

PRIVATE SECTOR PRIORITIES FOR BASEL REFORM

HEARING BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT OF THE COMMITTEE ON FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED NINTH CONGRESS FIRST SESSION

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PRIVATE SECTOR PRIORITIES FOR BASEL REFORM

Wednesday, September 28, 2005

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

The subcommittee met, pursuant to call, at 10:00 a.m., in Room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the subcommittee] Presiding.

Present: Representatives Bachus, Biggert, Feeney, Garrett of New Jersey, Neugebauer, Maloney, Sherman, Moore, Waters, Carson, Ford, Baca, Green, Clay, and Frank (ex officio).

Also Present: Representative Kennedy.

Chairman BACHUS. Good morning. The Subcommittee on Financial Institutions and Consumer Credit will come to order.

Just to give you a brief history of this committee and what we have been doing with regard to Basel, on May the 24th we conducted a joint hearing with Congresswoman Pryce, or Chairwoman Pryce's committee on this legislation, and we heard from the regulators. In addition, the subcommittee heard from the former Fed economist who left the Fed after their study of Basel's impact on residential mortgages was rejected, which we found quite alarming.

The prior March, this last March we—a bipartisan group of Members induced the same legislation we did in the previous Congress, H.R. 1226, the United States Policy Committee for Fair Capital Standards Act, which required the regulators to reach agreement before moving forward on Basel II. H.R. 1226 currently has 38 cosponsors, including Mrs. Maloney, Chairman Oxley, and Ranking Member Frank.

Today, we hear from the private sector. Our subcommittee will hold another hearing with the regulators after they return from the Basel Committee meetings in Europe next week, and that is why we did not have the regulators. We wanted to hear from the private sector today and then the regulators later.

I think the thing I would stress most about this hearing and about Basel II is that I believe there is a strong consensus from this committee that we want the regulators to understand that the committee is very concerned about the Basel II proposal, and I strongly believe they should first issue a Basel IA proposal and only after doing that address Basel II by extending the effective date for Basel II.

At this time I will recognize the ranking member of the full committee.

[The prepared statement of Hon. Spencer Bachus can be found on page 32 in the appendix.]

Mr. FRANK. I thank the chairman. I appreciate the leadership that both he and the chairman of the full committee have given this committee. I think this committee is—well, yesterday, in fact, we were congratulating ourselves legitimately for the role we have played—again, the gentleman from Alabama was a major player in this—in pushing for debt relief for the poor countries. I think the agreement that was recently reached for debt relief for the highly indebted poor countries owes a lot to the bipartisan work of members of this committee.

Today we are talking about another area involving international economic activity where this committee has taken a role. And at first, when we began to look into the Basel issue, to be honest, we were treated by some—including many at the Federal Reserve—as ignorant peasants I guess would be the best phrase. We were dealing with something beyond our understanding and we were being parochial.

What we found was that the way this was structured; serious reservations from bank regulators other than the Federal Reserve were being minimized, serious concerns from the financial services community were being ignored, and the more we looked into this, the more we became confident that we were, in fact, doing something very important and very constructive. And I think, again, this committee deserves some credit in a wholly bipartisan way. It was the chairman of the full committee, the chairman of the subcommittee, myself, the gentlewoman from New York, Mrs. Maloney, and others, who had worked on this. And it became clear to us that the Federal Reserve was going ahead without fully considering implications and expecting a degree of deference that is inappropriate in our society.

What we now have, I think, is a genuine examination of the issues. In fact, along these lines, I would ask, Mr. Chairman, to put into the record the letter to the Federal Reserve, the Comptroller of the Currency, the Director of OTS, and the Chairman of the FDIC; and it is a letter from the Conference of State Bank Supervisors dated September 6th. And just to quote briefly, We strongly urge the Federal banking agencies to obtain a much better sense of the real-life ramifications of executing Basel II prior to giving any indication to our foreign counterparts about implementation.

And in the conclusion, Basel II makes a large impact for the future of the U.S. financial system. Accordingly, CSBS strongly urges the Federal banking agencies to conduct further analysis of potential capital changes that would ensue from adopting the proposal.

So we have the Conference of State Bank Supervisors saying, slow down; we have heard that from the head of the Federal Deposit Insurance Corporation; the new Comptroller of the Currency recently appointed by the President—recently appointed and recently confirmed, also has concerns. So we have very serious concerns.

And originally we were worried about the capital charge on people who were holding securities. Now we have very widespread concern about the impact on the differential and capital requirements.

One of the things that we are all agreed on, I think, here is that while large banks are very nice to have, we don't want to see the trend towards them being the only banks accelerated. You know, we are doing this as the Committee on Banking; in Massachusetts, the corresponding committee is called the Committee on Banks and Banking. And someone said, are you ever going to change your name? I said, yes, but by the time we do, we may call it the Committee on the Bank because there will be one.

We don't want to see this, and it does appear that there is a broad consensus that, as now proposed, Basel II accelerates a trend towards consolidation. If consolidation happens naturally through economic forces, that is one thing; regulations shouldn't be encouraging it.

And the last thing I would say is this, Mr. Chairman: One is that I hope we will hear from the Fed. We have heard from a number of responsible, knowledgeable people, both from the bank industry and the bank regulators—again, the Conference of State Bank Supervisors, the Comptroller of the Currency, the FDIC board. We have heard about their concerns.

I am unclear today as to what Basel II is trying to correct. What are the great problems that need this attention? It is arguable that it may make things somewhat better, but I see concern on the one hand about what the consequences would be, and I have not yet seen any dire picture of the consequences of inaction. And I guess I think it is incumbent on those who are the advocates of prompt action on Basel II and the advocates of those who would disregard a lot of these requests for slowdown that we have gotten and for reconsideration, I would like for them to tell me what it is that is giving them this sense of urgency because as I look at the record and I think back about our hearings, I don't see it.

So I think it is one more useful step, Mr. Chairman, in our trying to get this process done right, and I appreciate your continuing this initiative. And I ask, as I said, that this be put in the record.

Chairman BACHUS. I thank the ranking member.

At this time we are going to hear from the panel. And Mr. Manzullo, I am going to recognize you to introduce—

Mr. MANZULLO. Thank you very much. I am not a member of your subcommittee, but I have plotted myself here because one of our witnesses is my constituent. And I could take this time just to introduce her; then I have to leave at 10:30.

Kathy Marinangel comes from McHenry County, which is in the far eastern portion of our congressional district. And when I was first appointed to the Banking Committee some years ago, I got this excited call. And I stopped by her office and she began to share with me all the concerns going on in the banking industry. And I said, my gosh, I need to go to banking school; I just can't keep up with the extent and width of her knowledge. In fact, when I first heard of Basel, I thought it was the sweet basil that my dad put on his pasta in the Italian restaurant that the family owned.

But Kathy has taken an extraordinary amount of time to inform me and instruct me on the issues, and I am absolutely thrilled that

she is coming here all the way from McHenry County, Illinois, to share with this committee her thoughts and her wisdom.

And, Kathy, welcome to Washington. I appreciate your coming here, and I guess we are getting together later on today. Thank you.

Ms. MARINANGEL. Thank you, Congressman.

Chairman BACHUS. Thank you. I appreciate that, Chairman Manzullo.

Congressman Manzullo is the chairman of the Small Business Committee and also an important member of our committee, so thank you.

Our two other panelists are Mr. Wilson Ervin, managing director and head of Strategic Risk Management for Credit Suisse First Boston. And you are here representing The Financial Services Roundtable?

Mr. ERVIN. Yes, sir.

Chairman BACHUS. As well as, I guess, Credit Suisse First Boston.

And Mrs. Karen Petrou, Managing Partner of Federal Financial Analytics. And you testified before this committee prior, have you not?

Ms. PETROU. Yes, sir.

Chairman BACHUS. So at this time we will hear from our witnesses.

The one thing I did not say in my opening statement—I had the wrong opening statement. When I got ready to read my opening statement, it was for the committee hearing tomorrow, so this usually goes a little smoother. And that was my fault, it was—

Mr. FRANK. Will the gentleman yield? Does that mean we won't have to listen tomorrow?

Chairman BACHUS. But I could go ahead and have given that. So that was a total ad lib.

But one thing I did not say, that was in the statement that I intended to read was that several months ago the regulators announced plans to delay the Basel notice of proposed rule making in response to the Qualitative Impact Study 4, which showed huge swings in capital. Despite all that, the Fed says they are still committed to the January 2008 date for full implementation of Basel. And that is what disturbs us, the fact that we have gotten a lot of information which the regulators didn't expect, we didn't expect, and there is disagreement among the regulators.

We still don't have our Basel IA proposal and we are still moving forward with Basel II with all these uncertainties.

And as I mentioned, the former Fed economist that issued a study to the Fed—and the Fed chose to reject it—from folks that had been there for years and years, and they testified before our committee and Chairwoman Pryce's committee back in May. So we—and as Congressman Frank, Ranking Member Frank said, we are very concerned about this. We are hearing from numerous institutions about concerns they have also.

So at this time we will start with Ms. Marinangel, and welcome all three of you to the committee.

**STATEMENT OF KATHLEEN E. MARINANGEL, CHAIRMAN,
PRESIDENT AND CEO, McHENRY SAVINGS BANK, McHENRY,
ILLINOIS, AND MEMBER, BOARD OF DIRECTORS, AMERICA'S
COMMUNITY BANKERS**

Ms. MARINANGEL. Thank you, Chairman Bachus.

Chairman Bachus, Ranking Member Sanders, and members of the subcommittee, my name is Kathleen Marinangel. I am chairman, president and chief executive officer of McHenry Savings Bank located in McHenry, Illinois. We are a \$250-million community bank focused on retail customers and small business owners. We compete head to head with many large national and regional banks.

I appear today on behalf of America's Community Bankers where I am a member of the board of directors. Thank you for this opportunity to present our views.

ACB and its members have taken a lead for some time now in raising issues about Basel II and requesting simultaneous changes to Basel I. ACB does not oppose implementation of Basel II.

As we testified before this subcommittee last spring, we support the efforts of U.S. and global bank supervisors to more closely link minimum capital requirements with an institution's risk profile. However, prior to adoption, legislators, regulators, and the industry need to evaluate the complexity of the proposal, its competitive impact, and the ability of regulators to monitor compliance.

We believe that a regulatory capital floor must remain in place to mitigate the imprecision inherent in internal ratings-based systems; however, the precise level of the leverage requirement should be open for discussion.

Institutions that comply with Basel II, and possibly institutions that comply with a more risk-sensitive Basel IA, may not achieve the full benefits of more risk-sensitive capital requirements because they may push up against the leverage ratio. We understand that the European Community is pushing ahead to implement Basel II and is pressing for agreement on certain issues.

The U.S. regulators attending a quarterly meeting next week in Basel should make no commitments to their foreign counterparts in light of the still evolving nature of Basel II implementation in the U.S.

The complexity and cost of development and implementation of a risk-based model likely will preclude all but a small number of banks from taking advantage of the more risk-sensitive capital regime in Basel II. The best available evidence suggests that this will open the door to competitive inequities.

The most recent quantitative impact study on Basel II showed significant reductions in capital requirements for many of the participants. Capital requirements for mortgage loans dropped by more than 70 percent for some organizations. These results caused the regulators to delay further action on Basel II while they conduct additional analysis. No further information about this ongoing analysis has been released.

As a community banker, I, along with ACB, strongly believe that Basel I must be revised to have more risk-sensitive options at the same time that Basel II moves forward. A revised Basel IA needs to include more baskets and a breakdown of particular assets into

multiple baskets to take into consideration collateral values, loan-to-value ratios, and credit scores. Credit mitigation measures and other revisions could be incorporated into the framework.

Advances in technology and the availability of more sophisticated software would make implementation of Basel IA relatively straightforward for most community banks. For my bank, there would be no burden and a lot of benefit. The bank regulators also could adopt a simplified risk-modeling approach that is consistent with the less complex operations of most community banks.

The smallest of community banks should have the option of continuing to comply with Basel I as it is currently constituted if they would prefer to remain compliant with the less risk-sensitive capital scheme.

The bank regulators have listened to our comments and suggestions and are moving forward to develop a Basel IA. ACB would like to commend the regulators for initiating a dialogue with representatives from the industry this summer about possible Basel I changes. Our understanding is that an advance notice of proposed rulemaking addressing possible changes to the framework may be issued as early as next month. ACB will continue to be actively engaged in this process to develop Basel IA.

I wish to thank Chairman Bachus, Ranking Member Sanders, and the rest of the subcommittee members in giving ACB this opportunity to present our views. There is no more important issue to community banks than the implementation of Basel II and long-overdue changes to Basel I requirements.

I would be happy to answer any of your questions. Thank you. Chairman BACHUS. Thank you.

[The prepared statement of Kathleen E. Marinangel can be found on page 45 in the appendix.]

Chairman BACHUS. Mr. Ervin.

STATEMENT OF D. WILSON ERVIN, ON BEHALF OF CREDIT SUISSE FIRST BOSTON AND THE FINANCIAL SERVICES ROUNDTABLE

Mr. ERVIN. Good morning, Mr. Chairman; thank you. I want to thank you for holding these hearings today and inviting me to appear before the committee.

My name is Wilson Ervin and I am a managing director of Credit Suisse First Boston. I am head of their Strategic Risk Management Department and am presenting testimony today on behalf of the CSFB and The Financial Services Roundtable.

CSFB employs approximately 20,000 people, primarily in the United States, and is a major participant in the capital markets. We have submitted written comments, but I will try and summarize those in my testimony today.

The Basel II capital proposals have been the topic of intense discussion and debate in the financial and regulatory community for the past several years. The industry supports the objectives of the Basel process to better align regulatory capital to underlying economic risks, to promote better risk management, and foster international consistency in regulatory standards. The impacts of these seemingly technical discussions will affect banks, markets, and the

economy in a deep way, and the committee is wise to consider the effects carefully before implementation.

Before I start, I would like to note that I have personally developed tremendous respect for the diligence and stamina of the regulators who have worked on Basel II, as well as a review provided by Congress. They have had to address a great many complex and challenging issues and have been tenacious in trying to develop a best-practice solution for each.

I wish to express appreciation for Federal Reserve Governor Bies and Vice Chairman Roger Ferguson, who met with CSFB and The Roundtable on a number of occasions to listen to our concerns. The OCC, FDIC, and OTS have also had open doors during this process.

Basel II has considerable momentum, and most people believe that it will be likely implemented in the near future. However, as in all complex undertakings, the Basel document in its current state, it is far from perfect. On balance, we believe the advantages of the reform substantially outweigh the drawbacks, but further improvements are still possible and desirable.

Today, without getting too involved in the technical details of the Accord, I would like to highlight three issues that we believe are particularly important as the Accord moves forward: number one, adjustments to the recent trading book review; number two, the practical implementation of complex cross-border regulation or the home-host issue; and number three, principles-based interpretation.

The first topic I want to discuss is the recently completed trading book review. For several years now the discussion regarding Basel II has focused primarily on credit risk capital, and this area has been continually reviewed and reshaped in an open, transparent process. For a combination of reasons, it was recently determined that a separate discussion of capital charges for market risk inherent in traded credit and equity portfolios would also be necessary.

Because of the tight timetable, the new trading book proposals involving market risk, the so-called "Strand 3" of the trading book review, have been designed and evaluated over a period of just months rather than the period of years that the rest of the Accord has been subject to.

The first draft of the new trading book standards was just seen in April, with one round of comment and the final version in July. Not surprisingly, there remain many areas where regulators in the industry recognize that continued refinement will be necessary.

During the development stage, regulators have had a number of sessions with the industry to discuss certain problems found in the trading book drafts. In these sessions, members of the BIS-IOSCO Working Group provided helpful guidance on their specific intentions. The industry appreciated this clarification greatly and concluded that the general final language could work in practice with the interpretation that they heard directly from senior regulators.

Given the reliance placed by firms on the information provided in these sessions, we believe it makes sense to record these understandings. This will ensure transparency of the regulators' intention and give industry participants greater confidence to move forward with the investments required to begin implementation of the trading book standards.

In addition, it is worth noting that the new trading book requirements have only recently been published, and there remains work to be done to flesh out how they should be implemented in practice.

In addition, no comprehensive impact statement has been performed to date; we believe this is a key gap that must be closed. We suggest that all regulators take advantage of the existing provision deferring the effective date of this portion of the Accord until 2010 so that refinement impact analysis and final implementation can be done in an orderly, consistent manner. This timetable could be separate and apart from the rest of the trading book review and the bulk of the Accord, if necessary.

The second topic I would like to address is the complexity of the new rules across jurisdictions, the so-called "home-host issue," which poses particular challenges for an international bank that is regulated by supervisors in multiple countries. CSFB, for example, will be required to implement Basel II as a Swiss bank, a U.S. financial holding company, a U.K. Bank, and a regulated financial institution in more than 30 other countries. Our implementation will be governed primarily by the Swiss Federal Banking Commission in conjunction with the Federal Reserve in the U.S. and the FSA in the U.K., but also by many others.

Most international banks face a similar set of interlocking regulations in which both home and host countries interpret and enforce rules. This can give rise to conflicts even under an international standard like Basel II. At times, we have been given conflicting guidance by both home and host regulators under the existing Basel I Accord, which makes compliance very difficult. It is a Catch-22.

While we have been able to resolve these issues to date, the potential tension between home and host regulators will become a much bigger issue going forward, given that Basel II is much wider and much more detailed. If each country decides to require its own local rules and data for each of the many calculations in Basel II, the compliance burden will go from bad to impossible.

The Basel Committee has formed an Accord Implementation Group to deal with these issues, but to date there has been very little tangible guidance. We believe that a stronger proposal should be developed to resolve these conflicts in a timely and predictable manner, and we have made some suggestions in our written testimony.

The last area I would like to talk about is principles-based interpretation and the need for flexibility.

The Basel rules are based on the financial markets as they work today, but they are so complex and heavily negotiated they will be difficult to update over time. We strongly believe that regulators ultimately will need to place a renewed emphasis on the principles behind Basel II, specifically those in the Pillar II section of the Accord, as a matter of either law or practice.

This principles-based approach, subject to reasonable benchmarks and guidelines to maintain consistency, has some important natural advantages compared to Pillar I's complex "black-letter" style. This permits steady evolutionary improvement to keep up with markets and should, therefore, be more durable and relevant than Pillar I rules that are designed with today's market in mind.

Addressing the question of an evolving Accord will not be simple. If the rules were all applied as black-letter law and interpreted strictly, the new rules will be both costly—since risk-management advances that led to Basel II won't stop today—and potentially irrelevant to ongoing best practice.

One example of this relates to operational risk, an area that is relatively new in terms of risk management discipline and quantification. There is a danger that certain approaches can be mandated as, quote, "best practice" by regulators in some jurisdictions, even though development in this area is far from complete. It is imperative that we avoid few fixed requirements where they arise solely from interpretations by certain examiners.

We encourage an approach that emphasizes principles and simplicity as the rules are implemented and a less burdensome "trust but verify" approach to compliance. Specifically, regulators will need to emphasize that compliance with the rules will not be based on many layers of "box checking," but with a spirit of the rules based on economic principles.

We are at an important stage in the reform effort, perhaps the last leg of a long race. A lot of good, hard work in designing the framework and getting some political consensus has been accomplished. We have high regard for the efforts of the committee and the regulators who have worked so hard to capture best practices and risk assessment.

CSFB and The Roundtable have tried to contribute to the specifics of those discussions in a constructive manner and submit our three proposals discussed today—trading book review, cross-border implementation, and principles-based interpretation—in that light. We believe that refinements are still possible and desirable and that these changes will help make the Accord more effective in practice.

As a final comment, I believe that regulators will need to look beyond the detailed calculations embedded in the rules and focus on the overall quality, thoughtfulness, and the integrity of bank risk management to implement the Accord successfully. This will place the burden of responsibility back where it should be, on the shoulders of bank management, to demonstrate to regulators and the public that they are doing a good job.

That is in the spirit of the Sarbanes-Oxley reforms in the United States, and I think that is a smart and durable way to improve financial discipline and live up to the origin goals of the Basel project. Thank you.

Chairman BACHUS. Thank you.

[The prepared statement of D. Wilson Ervin can be found on page 35 in the appendix.]

Chairman BACHUS. Ms. Petrou.

**STATEMENT OF KAREN SHAW PETROU, MANAGING PARTNER,
FEDERAL FINANCIAL ANALYTICS, INC.**

Ms. PETROU. Thank you, Mr. Chairman. It is a pleasure and an honor to appear before this subcommittee. I thank you very much for the opportunity, again, to talk about this important rule.

The subcommittee, and indeed all of the Financial Services Committee, has done what is often so difficult: You have anticipated a

problem and tried to step in with congressional leadership to solve it before it happens. And I think that has been of tremendous assistance as the regulators think through the Basel II Accord.

My name is Karen Shaw Petrou. I am managing partner of Federal Financial Analytics, and we have done a considerable amount of work on the Basel II Accord for a variety of industry clients.

As we look at the Accord and its current state, I really do think a very difficult decision awaits you and the U.S. regulators. As you have mentioned, Chairman Bachus, the agencies will be going to Basel next week. And I know there is strong impetus in many quarters to agree to the Basel II framework, but I do believe this will be very problematic, in part, because it remains still unclear what that is.

The Financial Services Authority recently issued 50 pages of areas of national discretion in Basel II, and, therefore, it will look very different in each country that implements it.

The U.S. has taken a particularly independent tack. We are, as you know, proposing to implement Basel II only for the largest institutions, and as your committee has established, this raises very serious competitiveness problems.

We have a unique financial system with thousands of independent financial institutions that play a very important role in this Nation, and we must think that through very carefully. We have a leverage requirement, again unique, that throws Basel II into a very new framework, and it is one that requires quite careful consideration so that all of the work to go to make a risk-based capital rule is not made moot because of our leverage requirement.

In short, we have a very different framework, and it will make it hard to take Basel II—whatever, indeed, that truly is—in whole or in part, and apply it only to our largest institutions. I do think that would be putting the square peg of Basel II into the round hole of our financial industry, not a good conclusion.

On the other hand, however, I do also believe that we can't just keep Basel I. We know Basel I is not a good risk-based capital system. It is very crude. It permits undue risk-taking, and that is why the agencies rightly started the Basel II process several years ago.

More importantly, like it or not, Basel II is a done deal. With all the variations I have mentioned, it is still a final framework now everywhere but here. That means, starting January 1, 2007, banks in the EU, Canada, Japan, and elsewhere, many of which do considerable amounts of business here, will come under a new risk-based capital framework that could well make them merger-and-acquisition powerhouses.

In short, if I may say so, I think we are in the midst of a "damned if we do, damned if we don't" dilemma. Going forward with Basel II as the agencies have proposed will not work; staying under Basel I will not work; and I think waiting is a dangerous strategy because the rest of the world will move on into this new capital framework regardless of what we do.

If I may, then, I would like to offer what I hope is a middle course, things we could do now that I do not think pose the competitiveness problems brought about by either waiting and retaining Basel I or implementing Basel II for only the largest banks and only the most advanced forms on the schedule now on the table.

First, I would suggest that the U.S. move quickly to adopt the credit risk provisions in the standardized sections of the final Basel II framework. These are relatively simple; they could be Basel IA. We—I think even small community banks that wish to take advantage of this could do so because the standardized option sets simple risk formulas, but has some very constructive incentives for recognizing risk mitigation and for penalizing high risk.

We should do this for all institutions, not just some, to avoid the competitiveness problems. I understand that the standardized credit risk section is crude and in many ways imperfect and capital under it may still be too high, but I think waiting will lead us to the error of letting the perfect be the enemy of the good. And again, the longer we wait, the more Basel II elsewhere will become a potentially very serious competitiveness problem for banks here, even smaller ones.

Second, I would suggest a hard look at the leverage ratio. I know that many feel that it would be both a competitiveness protection—that if big banks must hold the 5 percent leverage requirement now in place even if their Basel II numbers dropped, they would not realize this and they could not be a competitiveness threat—but I would say the leverage requirement is very easy to game; it is a simple requirement of capital for on-balance sheet assets.

Large institutions can securitize assets or create so-called synthetic ones. This is not hard to do, and it is easiest, of course, for the largest institutions. It is a game, but it is one that they are good at, so keeping a leverage requirement in place will not protect small institutions.

It will also, I think, have unanticipated safety and soundness problems. One can make the leverage requirement work on a low-risk book of business by topping it off with what one might call "toxic waste," and then the numbers work out fine, but I am not sure why the agencies want banks to do that. They have the flexibility under current law to go into a far more sophisticated leverage requirement and, hopefully, ultimately eliminate it; and I hope that is what we do in conjunction with implementing both Basel IA and Basel II.

Thirdly, the operational risk-based capital requirement in Basel II will, I think, have unanticipated and perverse incentives that would undermine effective operational risk management. We should have a rigorous, enforced, supervisory framework that ensures that institutions engage in the contingency planning and disaster preparedness that not only proved themselves on 9/11, but again were so critical in the cleanup from Hurricane Katrina and Hurricane Rita. There is a lot left to do here, and a new capital charge would divert essential financial industry resources from emergency preparedness, clearly something we must remember to take very, very seriously.

Finally, I do think the advanced options in Basel for credit and operational risk do make sense. They are more sophisticated than the standardized approach, and they do accomplish the valuable goal of bringing regulatory capital better in line with real risk. We should move forward on that to the degree we can in the Basel II framework, but we should do it for all institutions, not just for the big ones. And we should take careful heed of our own realities—

tax law here, for example; we should look at that as we define capital.

We have a very proven risk mitigation environment with various forms of insurance and guarantees. Those should be reflected in capital. And perhaps we, because of the nature of our very sophisticated financial system, should take the lead in further recognition of internal models in a principles-based supervisory framework.

But in closing, I would say that, like it or not, Basel II is about to be a reality, so we must make policy decisions to ensure that our institutions remain competitive and serve their customers in every community.

Thank you very much. I would be happy to answer any of your questions.

[The prepared statement of Karen Shaw Petrou can be found on page 52 in the appendix.]

Chairman BACHUS. Thank you.

Ms. Petrou, you mentioned near the end of your statement Hurricane Rita and Hurricane Katrina, which obviously have taken a lot of the focus of the Nation on responding to the devastation there. And you mentioned a possible tie between the Basel proposal, Basel Reform and Katrina and Rita. And I guess that is the issue of operational risk.

Ms. PETROU. Yes, sir.

Chairman BACHUS. If the operational risk charge in Basel II had been in effect presently, how would that affect the banks' and the regulators' ability to respond to what we saw in Texas and Louisiana?

You know, they did a very good job, I think a wonderful job, but would Basel II—had it been in effect, would it have affected that?

Ms. PETROU. I think it might have undermined the very good response we have seen that comes from, as you know all too well, backup computers, contingency planning, heroism, hard work, an array of factors that you can't quantify and which cannot, I think, be turned into a capital charge.

A capital charge is basically money in your pocket that the regulators say you must have so that if things you don't expect happen, you can protect your institution from failure by virtue of that extra bag of coins in your pocket. But it takes away from the coins you have for backup computers, contingency planning, disasters, telecommunication structures, independent electricity, all of the things we know institutions have to have and which they still do not have.

The agencies have moved forward with sound principles; they have done more work on contingency planning since 9/11, but there is a great deal left to do. And I do think a capital charge could divert resources from those essential tasks.

Chairman BACHUS. Thank you.

And I would direct the members of this committee's attention to page 6 of her testimony, which deals with the standardized Basel II options and how it could have interfered.

And I agree with the response, just the rigidity of the proposal in not anticipating something like this.

In the time I have remaining, about 2 minutes, I want to address the competitive issue. We are all concerned about the adverse impact that Basel might have, Basel II on competition. And mainly

because many banks will not adopt Basel II, others won't be able to, will they be at a competitive disadvantage?

Ms. Marinangel, you mentioned that in your testimony. The Federal—the former Federal Reserve economist testified before us that they believe it will have a negative impact on competition due to the differences in capital changes.

And so I would ask Mr. Ervin and Ms. Petrou, would you address this issue?

Ms. Marinangel, you did address it, I think, in your testimony, that you believe it will have a negative effect on many of our institutions.

But Mr. Ervin and Ms. Petrou, would you all like to respond to that?

And you also mentioned it, Ms. Petrou, but just elaborate.

Mr. ERVIN. If I may, I just want to—this goes a little bit to Karen's "damned if you do, damned if you don't" problem.

There may well be some competitiveness issues within the United States from implementing Basel II. We also have to be mindful that for large institutions such as mine, there will be competitiveness issues with other banks around the globe. So there is no magic bullet with a go-slow approach; we do have to deal with the reality that the rest of the world is moving to Basel II and that competitive equity between U.S. institutions competing globally and other European or Asian institutions will be an important thing to keep in mind as we find the right path forward for the United States.

Chairman BACHUS. What about what Ms. Petrou talked about, Basel and what I mentioned in my opening statement about a possible Basel IA proposal?

And Ms. Marinangel, what about that?

And I thought she put it very succinctly, that time is running, but other countries have adopted these standards. It could be a competitive disadvantage in our dealings with them, but then—

Ms. MARINANGEL. Well, I would like to state that, for example, in my town, I have approximately 18 banks and in the county 39 different institutions; some of them are foreign banks.

One of the competitive issues to think about—and I would like to do an analogy of four gas stations, one on each corner. If one of the gas station's price of gas is 4 cents cheaper than the others, where will all the business go?

Well, in the community banks world, as well, we are out competing with all of the foreign banks as well as large regional and national banks, and because of the economies of scale and guarantee fees and other issues just in the mortgage loan area, we have to be competitive to get assets on our books. And so it is a very critical disadvantage for us if we don't have Basel IA modification so that we can remain competitive. And that is just in the mortgage area, not even considering the other assets where the banks would be able to hold less capital.

And I agree, it is very critical because of the European countries adopting Basel II and the parliament approving the legislative issue on that. We really need to move quickly, but IA has to be considered for community banks. We need to deploy our capital as effectively—publicly traded banks need to do that, as well, to make

their good—our rates to be competitive so that we do maintain a community banking system in the United States.

I don't believe the European countries, when I was called by David Keith from the Global Risk Regulator, do not understand the community bank system in the United States, and it is critical that we maintain the system. And I have nothing against large banks. However, we do serve a different need, I think, in the United States, and it has to be protected.

Chairman BACHUS. Thank you.

Ms. Petrou.

Ms. PETROU. I certainly agree with all the comments today. I mean, the basic measure of bank profitability is return on equity, ROE. Equity is your capital, and you have to hold the higher of economic or regulatory capital. So when regulatory capital is higher than you have to have, or higher than other institutions are permitted by their agencies to have, you, if you are a large bank, small bank, sideways, suffer a significant competitive disadvantage, all other things held equal. And it is a hard one no matter how smart, how efficient you are to overcome.

I know this committee is wrestling with the GSE reform issue, and I have been honored to testify before other subcommittees on that. And one of the key competitiveness advantages Fannie and Freddie have is their very low regulatory capital. We see it in the marketplace. So it is not a fiction; it is a reality that will hit us very soon if U.S. policy stays as is.

Chairman BACHUS. Thank you.

At this time, I recognize the ranking member, Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman.

I will confess that I may not have been paying enough attention. I am very disturbed. I appreciate Ms. Petrou pointing out that we are in this situation where Basel II, if it goes into effect, coerces us some. And I tell you, I am on the verge of charging the Fed with bad faith.

During these conversations, when we raised issues, the Federal Reserve witnesses have consistently said to us, well, don't worry; nothing is conclusive here. And indeed, even if we agree to this, you will then have to have it implemented domestically. And we have got a kind of bait-and-switch here.

My recollection—and I see the May comments; I didn't see them in time; we had other things going on, GSE legislation. But for Governor Bies now to tell us that we will be at a disadvantage if we don't go ahead really seems to me to raise an issue of good faith because the Fed was telling us for several years that this was still being discussed and that even after they concluded an agreement, we would still have to have that implemented by domestic choices.

We are now being told that that is really not true, that in fact they are—having gone ahead, ignoring our concerns, frankly pooh-poohing us, and saying don't worry about this—now they are going to turn around and say, now you have got to do these things.

So I am going to recommend, Mr. Chairman, to yourself, the chairman of the full committee and all of the staff on our side, I think what is incumbent upon us now is to start preparing for that situation and do the best we can to minimize this.

And I will say this: I will feel no—ordinarily, I think in this committee we have been very much interested in international cooperation. I know we have talked with, many of us, the European Union and others about how to harmonize accounting requirements, how to prevent Sarbanes-Oxley from causing divergence.

As I mentioned earlier, you, Mr. Chairman, and others of us on the committee, the gentlewoman from New York and others, we have been very active with regard to the debt situation for poor countries. But in this situation, I do not feel coerced by the argument that we have to show good faith for international obligations, because I think the Fed frankly misled us in this regard.

And I think it is entirely reasonable for the staff of this committee, majority and minority, to get together, and Ms. Petrou has set out the approach I think we should take. I think it is important for us now to figure out ways that we can blunt the effect of an agreement, domestically, to which we are not a party.

And I do not believe the Federal Reserve ought to be considered the entity that can commit the United States Government. Someone should raise this issue. In the legislation we filed, we said we didn't want the Fed to have this autonomy. They kept telling us, oh, don't worry; this is only an agreement framework and you are going to have to fill it in.

We are now being told apparently—and I don't challenge this—the fact of that agreement and given the ability of other financial institutions to operate fairly freely in the U.S., in fact, does coerce us, does have an impact on us. And I think we are now entitled, in self-defense, to figure out how to avoid that.

So I will be studying what Ms. Petrou suggested. I will be looking for other suggestions. That is, I am not ready to say, oh, yeah, now that Basel II is there, we are going to, in effect, have to concede that it is there and adjust to it. The Fed consistently told us that that would not be the case, and I think we have every right now to deal with that.

Obviously, we can't ignore reality. What we then do is, I think, begin to deal with that reality. And I want to put them on notice.

The argument that, okay, it is a done deal and you had better adjust to it will not persuade me. And instead, my instincts will be to try to resist what we didn't like that was concluded over our objection. And I really am disappointed, and I confess error: I did not notice that Governor Bies said this in May, but it is directly contrary to what we had heard from her and from Governor Ferguson. And that is where we are.

So I have no questions, but to say that I would invite all the witnesses and others to begin working with us to figure out how we deal with this situation.

And I would also say to the Fed that they have lost a great deal of credibility with me in this regard to have assured us—and I have heard those assurances; don't worry; nothing is conclusive; nothing is; this will still have to be implemented by U.S. policy—and now to be told that is not really the case, you have got to do these things. I don't accept that, and I think we should do everything we can to resist it.

Chairman BACHUS. Thank you. And let me acknowledge that Ranking Member Frank has really led the effort on this committee.

I think he is the most informed member of the committee on this issue.

Mrs. Maloney has been very involved in this issue with Chairman Oxley, but it is something that members on both sides of the aisle, we have worked in a very bipartisan or nonpartisan way on this. And I think that your testimony here today actually kind of—as Ranking Member Frank said, I think it has been very valuable to us.

And to Mr. Ervin—you, I think, said it—it is not a question of large institutions trying to gain an advantage over the smaller institutions or those that Basel II will apply to; it is a question of, you want to maintain your competitiveness with international banks and your competition, worldwide competition. At the same time, it—as proposed, it will impact negatively on some of our smaller institutions.

And I think, Ms. Petrou—you have, I think, in a very valuable manner said there is an option of fixing this thing, and I am very much—I think that this is some very valuable testimony.

Prior to recognizing the gentlelady from Illinois, Mrs. Biggert, who is going to take the Chair in my absence, I wanted to introduce, without objection—if there is no objection, I ask unanimous consent to introduce, first, a letter to the Honorable Alan Greenspan signed by Ranking Member Frank, Chairman Oxley, Ranking Member Carolyn Maloney of the Subcommittee on Domestic and International Monetary Policy and myself, dated September 13th, which says:

“Dr. Chairman Greenspan, we were disturbed by the attached American Banker article suggesting that Federal Reserve Board staff are actively discouraging Federal Reserve Bank staff from expressing independent views on the Basel II Capital Accord. This is a very important issue, as you know, and it is necessary for Congress to be fully informed. Clearly, it is inappropriate for there to be any effort to interfere with the information Congress receives.

“if this article is accurate, we ask that you please take the necessary steps to ensure that no Federal Reserve official interferes with Congress’ access to information.”

And without objection, I would like to offer that into the record.

Secondly, I would like to offer some written testimony on the Basel II Capital Accord, and it is called, A Guide for the Perplexed, dated September 21, 2005, authored by Raymond Natter. He was the U.S. Deputy General Counsel at the OCC for many years and is presently with Barnett Sivon and Natter. And I would like to introduce that without objection.

And so at this time I recognize Mrs. Biggert for her questions.

Mrs. BIGGERT. Thank you, Mr. Chairman. And it is nice to see Mrs. Marinangel back from Illinois, and also Ms. Petrou for being back again to help us here.

My first question, though, will be for Mr. Ervin.

It appears that a big improvement has been made in Basel rules to cover only unexpected credit risk, which allows the reserves and earnings to cover unexpected loss. And this probably better reflects risks without adverse competitive impact.

But why isn’t a comparable approach being taken for operational risk?

Mr. ERVIN. I think in part it is because operational risk is a tougher nut to crack; it is a much newer discipline. There has been a desire that I have heard from various regulators to put, as Karen said, some coins in your pocket for those events in order to have the right amount of capital at institutions. But, to date, it is very difficult to actually quantify those sorts of things, it is pretty hard to quantify the impact of a Hurricane Katrina, to assess the probability of a terrorist strike, or a computer virus.

So I would say right now we are working with cruder approaches, frankly, in operational risk. We are still finding our feet. Hopefully, we will be able to come up with the kind of improvements that you have seen in credit risks where you can be a little bit more precise about how you build the mouse trap, but today, in operational risk, we are trying to do the best with a difficult problem that is still, frankly, in its early days.

Mrs. BIGGERT. Thank you.

Ms. Petrou, do you see any improvements in the ability to manage and measure the operational risk and any time frame that this might take place?

Ms. PETROU. I do. And I think that the Basel II Accord has been a good impetus for industry attention to operational risk management.

The agencies have sometimes said that the reason they proposed the operational risk capital charge is to get people thinking about operational risk. I long thought they had a whole lot of other ways to get the banks they regulate to think about the things they want them to think about. And I would suggest that, again, contingency planning, disaster preparedness, backup systems, et cetera, are the first point of contact.

Operational risk is very different from credit risk because institutions don't take it for profit; they experience it as an adjunct to their businesses, and so they price for it, they hold reserves for it. And it needs, I think, to be treated very differently than credit risk as a result.

Mrs. BIGGERT. Thank you.

Then, Ms. Marinangel, I know that you are concerned about community bank competitiveness if Basel II applies to only the largest and biggest of banks. But it probably would be hard to bring Basel II to all institutions because of the cost and complexity.

Would it make sense to proceed with a Basel I or IA approach for all the institutions in the U.S. even if Basel II is not ready to be implemented?

Ms. MARINANGEL. Yes, absolutely. I agree that if Basel II is not ready to be implemented, a modified IA would serve all of the industry well, large and small, and it would make us all be still on a level playing field.

Yes, it is critical to do that.

Mrs. BIGGERT. How is that progressing? Who is working on Basel IA or modified?

Ms. MARINANGEL. Well, just last month I was in Washington at the end of July with the four Federal regulatory agencies, and it was a very good session. They wanted a bank advisory group for input, so they took it very seriously. We were very happy that they wanted bankers' input as well as the trade group input, and so I

believe that they are working on it. As I—last time when I was here I had developed a formula that I gave you as a sample that could be used, somewhat simple but still a good change. So they are—the regulators are working on it with the industry.

Mrs. BIGGERT. But this would just be a domestic policy.

Ms. MARINANGEL. As far as I know, yes.

Mrs. BIGGERT. Okay. Thank you. And I would yield back.

Chairman BACHUS. Thank you. I appreciate your participation and willingness to chair the hearing, Ms. Biggert.

At this time, I recognize Mrs. Maloney.

Mrs. MALONEY. I thank the gentleman for calling the hearing. It is very timely with the October 3 meeting in Switzerland, and I would like to be associated with all the remarks that really show alarm that the regulators are not in agreement. They are not in agreement and that they are showing internal conflict.

I do want to note the American Banker article that showed or said that the independent views on the Basel II Capital Accord were not being expressed and the dissenting views were not being expressed, and I find that very troubling. One of the things we are working on in Congress now is that dissenting views on whether or not you go to war within an administration, that the dissenting views should be made public. And I urge the chairman really to get the dissenting views that we asked for in our letter. They have not come back to us from the Fed, and certainly we should have them before going forward.

I thank all of the panelists, and I would like to go back to Karen Petrou's statement on page five that I found the most troubling of a lot of troubling, unanswered questions that came from all of the panelists, that our banks could be put at a disadvantage for merger and acquisition, making us likely targets because their capital requirements are lower than ours. I find that extremely troubling. I do not want to see our financial institutions bought by other international institutions, and I want to know what we should be doing about it. Would you elaborate on that? How can we protect ourselves or at least allow our institutions to be on an equal playing field with the international community?

Ms. PETROU. Thank you, Mrs. Maloney.

I think the goal would be to recognize economic capital to the best we can in a way that reflects our unique market. What concerns me very much is looking again, starting really January 1, 2007, if not before, at regulatory capital incentives that will drive deals instead of the underlying market efficiencies that should be the cause of merger and acquisition activity.

Mrs. MALONEY. So what can we do to protect our markets or to have our markets on an equal playing field?

Ms. PETROU. I would suggest that we move as quickly as possible to the more simple approaches in Basel II, the so-called standardized credit risk framework, making changes if we need to reflect our unique reality but ensuring that our regulatory capital isn't higher than regulatory capital applied to other competitors unless there is a sound safety and soundness reason.

Mrs. MALONEY. I think that is completely and totally reasonable. We certainly don't want to disadvantage our institutions with greater capital requirements.

Actually, I thought your testimony was very good because you actually had good recommendations. You came forward with specific recommendations for Basel implementation. Why do you think the regulators have not adopted your recommendations on operational risk, and what do you think will be the consequences of that decision, of not adopting your recommendations?

Ms. PETROU. I know they have listened to many voices. They are in a very difficult environment in which they are hoping for an international agreement and I think perhaps focusing on that. Sometimes the details of the Basel II Accord have taken precedence over, if I may put it, substance. These are very complex rules, and it is extremely easy, because of their profound impact, to get very, very distracted by how many basis points of this we need for that or what the K should be in the five-page formulas for securitization capital. It has been difficult sometimes to get back to the real policy impact because the models themselves are so complex.

Ms. MARINANGEL. If I might add, I think, as Karen has said, it comes down to the leveraging of capital. If we can leverage our capital and remain competitive, then we will be able to stay in business. When—if we can't—if the capital charges are greater for us than foreign banks, they would be able to buy our banks very quickly and deploy capital effectively and probably pay a higher price even for the bank, and it might be lucrative and attractive to the bank owners. So it is all a matter of leveraging capital. That is from my point of view.

Mrs. MALONEY. But, so far, they haven't made clear that position for our banks, so that is very troubling. And I think they should make that clear before they go forward.

Ms. MARINANGEL. I think I agree.

There are two approaches. One would be to try to implement a standardized approach, but I also believe that Basel IA would have the same effect, and it might be more easily and quickly established.

Mrs. MALONEY. Thank you.

Wilson Ervin, you mentioned the trading book in your testimony. Can you elaborate on that issue and discuss how it may impact your firm and similar firms under Basel II?

Mr. ERVIN. This is a relatively recent development in the Basel process. As you know, the Basel discussions have been going on for a large number of years now. But it was really only this year that we saw some significant changes happening to the trading book, the books that broker dealers as well as large international banks like ourselves have, that provide liquidity in the securities markets.

There was a concern that the rules which had previously been fixed under Basel I to assess capital and trading books were not consistent with all the new rules that were being developed for the credit side, so in some cases there were basically three strands of analysis in the trading book where this year they tried to come up with some changes to make those more in line.

I can't argue with the premise of trying to ensure consistency between trading and banking books, but they have had to do this under pretty tight deadlines. And, in particular, I think that the assessment of credit risks within traded market portfolios—think

about bond trading. Any time when you are trading securities issued by U.S. corporations or foreign corporations that have a credit risk component to them, the cost of some of those positions is going to be going up, which will have an impact on the securities market. We think that those proposals could use some more time, some more specific guidance from the regulators, as well as some impact assessments to make sure we really understand what we have done in this area.

Mrs. MALONEY. Well, my time is up, but I also was intrigued with your comments on the operational risk, and maybe in writing—my time is up now—if you could give specific recommendations and should it be in color one or two.

And just—Chairman Bachus, I want to thank you for your leadership, but also to say that if they will not give us the dissenting views of the members of the Federal Reserve and the staff dissenting views, I think we should foil them. I think this is important and that we should have all the information before us. But I do thank all of you for your insight and for your work on this issue, and it has been very helpful. Thank you.

Mrs. BIGGERT. [Presiding.] Thank you.

The gentleman from Texas, Mr. Neugebauer, is recognized for 5 minutes.

Mr. NEUGEBAUER. Thank you, Madam Chairman.

First of all, I want to thank America's Community Bankers' testimony today, Ms. Marinangel, for your testimony.

I think one of the things that, as we kind of look at this issue, is that there seems to be a lot of concern whether this issue is ripe right now. What would be your perspective as to do we need to move in the direction we are headed or do we need to stop and really kind of rethink this, the whole issue?

Ms. MARINANGEL. I think that we have to rethink the issue, look at all the competitive disadvantages that will occur. I think we need to really consider whether Basel II is appropriate or whether something in between is better for us. I think that the regulators and your committee are looking at this very closely, and I think we do have to take some action because of the foreign competition for the larger banks, especially here and others that are in our areas. And, yes, I think we do need to really study this quickly and come up with some conclusions as a group.

Mr. NEUGEBAUER. One of the concerns I have is if community bankers, particularly in my district, are such an integral part of a source of capital for our small businesses and yet they compete on a head-to-head basis with some of the large banks that are also in those same markets—so my concerns are that we don't want to create an unlevel playing field here for our community banks and hurt their ability to continue to do what they need to do in our communities. Do you see that that is a possibility?

Ms. MARINANGEL. Yes, that is why I am so focused on this issue. The community banks currently can compete because we offer some, we feel, personalized service. We know our customers well. The large banks also do a good job, as I say. I don't want to cause any disparaging remarks against them.

However, some of the burdens that are placed upon us are the regulatory issues that cause us to spend a lot of our funds in that

arena, and some are needed and maybe some are for us more burdensome because we don't have the same amount of staff as the large banks. And the capital issue is really critical. The pricing of the assets that large volumes, where they have advantages in pricing, that hurts us tremendously.

The public today is very aware of pricing because of all the media, and so it is hard to compete and our net interest margins might be squeezed a little more. So we have to look to other sources of income.

In the same light, we can't do the large credit card programs that allow the larger banks to have higher profit levels in the fee income area and some things.

So, yes, it is extremely critical. I do believe the community banking world does serve a wonderful purpose in the United States, and I would hate to see them not be able to compete because of capital issues.

Mr. NEUGEBAUER. Well, I agree with that. At the same token, though, we want to make sure we provide a financial environment in America that keeps all of our financial institutions competitive in a global economy because we are moving—whether some people like it or not, we are already involved in a global economy. So what are some of the suggestions that you would have as to allowing those institutions that want to be competing for more global—in a global market to be able to do that while allowing the community bankers to, you know, to set their sights on the marketplaces that they want to compete in?

Ms. MARINANGEL. Well, Basel really concerns risk-based capital. The leverage ratio is another issue, but risk-based capital does have some constraints because I can't run my bank the way I would like to because of capital constraints and I diversified my assets and I believe in repriceability for survivability. Therefore, I have to be able to compete in pricing our assets.

When you have mortgage loans, for example, that are all weighted the same, whether they are 20 percent or 90 percent loan to values, and when you have commercial real estate loans, for example, that are all weighted 100 percent but maybe they are a 50 percent loan to value based on outside appraisals, these assets then cause us to have to do business in other ways because we have to weight them so highly and we can't run our asset mix the way we want.

So the true pricing of assets is critical for community banks; the risk weighting is really critical, and that is what this is about, risk-weighted assets. We have to be able to hold capital based upon their true risk. That will allow us to be competitive, and it will allow us to hold less capital and leverage and be able to deploy our capital effectively and not be takeover targets.

Mr. NEUGEBAUER. Thank you for your testimony. I think my time has expired.

Mrs. BIGGERT. Thank you very much.

The gentlewoman from California, Ms. Waters, is recognized.

Ms. WATERS. Thank you very much, Madam Chairwoman.

I would like to thank all of our panelists here today.

I am very concerned about our community banks. I think they are extremely important, and they do provide personalized services. I wish them to be able to operate in a way that will allow them

to continue to provide these services, and they, too, must be able to operate with a profit.

I am very worried about something I heard this morning when you discussed Basel II and the potential for foreign banks to be able to buy out our community banks. That is precisely what I would not like to happen. I have been worried for some time that big banks—not just foreign banks but big banks—would increasingly become aggressive in buying out our community banks. At some point in time this may start to look attractive to our community banks and they may start to sell, and I certainly don't want that to happen.

So I guess my question is, who in the community banking world, who is working on Basel IA? Who is helping to put together the framework so that it can have some real discussion and our regulators can be forced to have to deal with an alternative to I and II? How is that developing?

Ms. MARINANGEL. If you don't mind, I would like to just take a first shot at that. I have been working on it since 1988 when it was first adopted.

But America's Community Bankers has taken the lead on this issue. They are the most informed. I know that ICBA represents small banks, but we have provided testimony and recommendations for many years now. But America's Community Bankers, I think, is the most knowledgeable that I am aware of. They have helped me come forth in the forums here, and they are very aggressively pursuing changes. I think they are very respected by the regulators as well in their opinions.

Now the other top-trade groups are also now starting to take an active role. But it has been America's Community Bankers. I know that Charlotte Bahin is here and Greg Mesack and Diane Casey-Landry. That is who has helped me implement bringing this to the forefront. And since 1988, I have been upset because bankers never had input into this formula that constrains us that is currently existing as Basel I.

Ms. WATERS. Thank you. I yield back the balance of my time.

Mrs. BIGGERT. I am concerned about the schedule for adopting Basel II. The announced notice of proposed rulemaking has been postponed because of the results of the QIS 4. But we don't know how long or whether the January 2008 implementation date is still firm. If the January 2008 date remains firm, it will have the effect of compressing the timetable by which implementing institutions will have to determine whether they will adopt Basel II or not. Do you see this as a problem?

I will start maybe with Ms. Petrou.

Ms. PETROU. Thank you, ma'am.

I do. I think it is a problem if we are on a different time frame from the other Nations because of the competitiveness issues we have discussed. I also think it would be a problem if we then implemented Basel II advanced options as is on the January 1, 2008, schedule because the delays so far have given large institutions little time to develop models. We still don't know what our rules are, and I know the banking agencies are running, asking mid-sized institutions now, for example, to choose between Basel II and Basel IA. But we don't really know what either of them is, so I think

right now it is a choice between, if I may, a rock and no place. Adding a Basel II 1/1/08 implementation date into all that uncertainty I think would be dangerous, and that is why I would suggest the more go-slow approach that still gives our banks the advantage of the standardized options as quickly as possible.

Mrs. BIGGERT. Thank you.

Mr. Ervin.

Mr. ERVIN. Yes, I would say I guess my institution is in the rock part of that particular issue. As an institution regulated by over 30 regulators, we have to move to Basel II I expect by January '08 unless there is an international consensus to delay. It would be problematic for large global institutions to have to juggle two or three different regimes during that transition period. That just makes a difficult job that much harder.

I do think there were a few areas where there are for the international group of banks, the larger institutions, some areas where a bit more time could be put into the process. Not all of this has to be implemented at the exact same time. We had some specific thoughts about the trading book review, the most recent of the changes for the advanced banks, that if that could be delayed to 2010 I think that would give us time for real impact testing for memorializing how it would really be implemented and I think could be a big benefit in terms of smoothing the implementation of this.

Mrs. BIGGERT. Thank you.

Mrs. Marinangel.

Ms. MARINANGEL. The question again was—just briefly.

Mrs. BIGGERT. The question was, because of the advanced notice of proposed rule, rulemaking has been postponed. Is this going to—and it is compressing the time for January 2008. Do you see this as a problem for different banks having to adopt Basel II or decide not to?

Ms. MARINANGEL. Yes, thank you. Yes, I do see it as a problem.

I know that the ANPR in Basel IA is projected to come out soon, and I think that will help. I know that Basel II is being delayed currently, and yet I think it will be a problem for the large banks that will be competing and will have to try to implement. It is going to make it harder to make a decision quickly. I know they are working on it now, but, yes.

Mrs. BIGGERT. Okay. Thank you.

Well, everybody seems to have left me, so I would note that some members may have additional questions for this panel which they may wish to submit in writing. And, without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

I would like to thank the panel, for the two of you that are returning, and Mr. Ervin for being here at this hearing, too. I think you have the expertise that we really need to help us as we move forward with our hearings on this and what is going to happen in this regard. So again thank you for coming.

With that, this hearing is adjourned.

[Whereupon, at 11:26 a.m., the subcommittee was adjourned.]

A P P E N D I X

September 28, 2005

Opening Statement
Chairman Michael G. Oxley
House Committee on Financial Services

Subcommittees on Financial Institutions and Consumer Credit "Private Sector
Priorities for Basel Reform"
September 28, 2005

I want to thank Chairman Bachus for calling today's hearing on the proposed changes to the Basel Accord. Chairman Bachus has been a real leader on the issue of Basel II reform. Significant changes to the proposal have been made in response to his concerns. Additionally, by bringing attention to this process, this Committee has seen increased cooperation among U.S. regulators who are developing Basel II. It is important that these entities work together because the entire U.S. banking system will be affected by Basel II.

I don't think you will find much argument that the Basel Accord is outdated and needs revision. It was developed in the late 1980s, before liquid markets for credit had been developed and before the derivatives and securitization markets had taken off. These developments have made the Basel Accord obsolete and prone to abuse.

I believe that U.S. regulators should continue working to update the Basel Accord so that all banks can benefit from changes in the obsolete framework.

In May, we heard from the U.S. regulators who will be in Switzerland next week to discuss Basel II. We saw at that hearing that considerable differences of opinion continue to exist within the U.S. regulatory community about the Basel II framework and its implications for U.S. banking and regulation. In addition, we learned that:

- Q-I-S 4 showed major swings in how much regulatory capital banks might need to hold using the new framework. Specifically, the Q-I-S 4 results showed estimated decreases of regulatory capital by as much as 40 to 60 percent as compared with the existing framework. In addition, the regulators were unable to tell us why these results came out the way that they did.

- The regulators were unable to tell us how the new framework might affect retail credit markets in the United States.
- The regulators were unable to tell us whether these results will create pressure to eliminate or change the leverage ratio in this country.
- The regulators were unable to tell us how regulators from different countries will work together to implement the framework for large banks in light of the large number of key areas where national discretion will continue to exist.

This is unacceptable.

In addition, very few European, Japanese, and Canadian banks participated in Q-I-S 4. Past Q-I-S exercises have shown widely disparate outcomes outside the United States as well, so there is reason to believe that the Q-I-S in Europe could generate results not too different from the American ones. Nonetheless, this morning, the European Parliament finalized the framework and timetable without knowing exactly what the impact will be. In fact, European banks will not even start working on a Q-I-S 5 until later this fall, after the legislative process in Europe is nearly completed.

I know concern exists in Europe that the United States will not implement Basel II or may not implement at the same time as Europe. I realize this might cause some regulatory burden and uncertainty among banks that operate on both sides of the Atlantic. And so I draw the conclusion that regulators on both sides of the Atlantic must be certain that they understand the likely impact of the new framework before they start asking banks to hold capital using it. Perhaps the European implementation should slow down to reflect these significant uncertainties regarding potential market impact rather than create pressure for the United States to rush through its process.

I believe that until better understanding exists regarding how Basel II will impact the markets, it would be irresponsible to finalize the framework globally or domestically. In addition, I think the U.S. regulators were wise to pause before finalizing Basel II. Significant changes to Basel II may be needed here and abroad before a final proposal is ready.

We have an additional issue in the United States regarding what kinds of improvements may be needed for banks that would use Basel II. I think it is imperative that the regulators share with banking community their thoughts on what a Basel I(a) approach may look like and how it relates to Basel II. It seems that this would be the most equitable way to make improvements to the capital standards. I am interested in hearing what the witnesses think about this idea and whether they have any insight into what Basel I(a) might contain.

Thank you and I look forward to hearing from the witnesses.

**OPENING STATEMENT OF
CHAIRMAN SPENCER BACHUS
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT
“PRIVATE SECTOR PRIORITIES FOR BASEL REFORM”
SEPTEMBER 28, 2005**

Good morning. The subcommittee meets to examine the proposed Basel II Capital Accord and its potential effects on the domestic and international banking systems. Today’s hearing is the fifth one that the Financial Services Committee has held on the Basel II proposal since the 106th Congress. Prior hearings have highlighted disagreements among the federal financial regulators as well as substantive problems. At the last hearing in May, we heard from the banking regulators. At that hearing, the regulators continued to display significant disagreement regarding whether the Basel II process should be delayed in order to address a variety of outstanding issues. Today we will hear from the private sector.

During the last Congress, in response to concerns about the Basel process, I along with Congresswoman Maloney, Chairman Oxley and Ranking Member Frank introduced H.R. 2043, the United States Financial Policy Committee for Fair Capital Standards Act. The legislation — which passed out of my subcommittee by a unanimous vote — mandated that the federal banking regulators develop a unified U.S. position among the agencies prior to entering into negotiations in the Basel Committee. In March, Congresswoman Maloney and I introduced the same legislation, H.R. 1226, which currently has 38 cosponsors. I want the regulators to understand that this Committee is very concerned about the Basel II proposal

and that they should first issue a Basel IA proposal and consider extending the effective date for Basel II.

The goal of Basel II is to develop a more flexible and forward-looking capital adequacy framework that better reflects the risks facing banks and encourages them to make ongoing improvements to their risk assessment capabilities. Over the past six years, United States Federal banking regulators have been engaged in negotiations with their foreign counterparts on possible improvements to the standards that govern the capital that depository institutions must hold against their assets. The Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) participate in the negotiations on behalf of the U.S. It is expected that, when ultimately implemented, Basel II will apply mainly to the largest, most internationally active banks, and others that voluntarily adopt it.

In recent years, a growing consensus has developed that Basel I is outdated and represents a one-size-fits-all approach to regulation, causing some banks to hold too much capital, thus diverting capital from productive lending activities. Additionally, Basel I has been criticized for exacerbating credit crunches, creating incentives for banks to undertake destabilizing short-term lending in emerging markets, and for not taking into consideration risk mitigation (e.g., collateral and guarantees).

I applaud the intent and objectives of the Basel II Agreement: to ensure solvency of our banking institutions and protect against substantial losses, and to create international standards to better manage risk and align regulatory capital to economic risk. Nonetheless I have concerns regarding Basel II on several grounds.

First, I believe it is unnecessarily complex and costly with inflexible formulas replacing current rules and supervisory examinations. Neither the U.S. regulators nor the Basel Committee are able to estimate the cost of implementing Basel II due to difficulties associated with scaling for different sizes of financial institutions and difficulties in assessing which costs would already have been undertaken by the banks in the ordinary course of enhancing their internal risk management systems. No U.S. banking regulator, nor any member of the Basel Committee, has indicated whether sufficient resources exist to implement Basel II.

In addition, I believe that the current draft would create an uneven playing field – one that unfairly penalized many banks in this country, particularly our regional banks. Many believe that “Basel II” banks will have a significant competitive advantage because they will need to hold less regulatory capital for certain asset classes (for example, credit cards; corporate lending; mortgages) and because market participants (for example, swap counterparties; credit rating agencies) will perceive Basel II banks to be better managed than Basel I banks. I am also concerned that bank consolidation could be accelerated solely because of the regulatory capital benefits associated with Basel II implementation. Another concern that I have with the proposal is the treatment of operational risk. It is my belief that a supervisory assessment by the regulator as opposed to a regulatory capital cover is the better approach to limiting a bank’s operational risk.

I am now pleased to recognize the Ranking Member, Mr. Sanders, for any opening statement that he would like to make.



Private Sector Priorities for Basel Reform

TESTIMONY OF D. WILSON ERVIN

on behalf of

Credit Suisse First Boston

and

The Financial Services Roundtable

**Hearing on Basel Capital Reforms
House Committee on Financial Services
Subcommittee on Financial Institutions & Consumer Credit
September 28, 2005**

**Testimony of D. Wilson Ervin
Hearing on Private Sector Priorities for Basel Reform
House Committee on Financial Services
Subcommittee on Financial Institutions & Consumer Credit
September 28, 2005**

Introduction

Good morning Mr. Chairman. I want to thank you for holding these hearings today and inviting me to appear before the Committee. My name is Wilson Ervin and I am a Managing Director of Credit Suisse First Boston ("CSFB").¹ I currently am head of CSFB's Strategic Risk Management department and have been named to be the Chief Risk Officer for Credit Suisse effective at the end of the year. I am presenting testimony today on behalf of CSFB and on behalf of our trade group, the Financial Services Roundtable.² CSFB employs approximately 20,000 people, primarily in the United States, and is a major participant in the capital markets. It ranks among the top firms in raising money for companies around the world and is a leading underwriter of mortgage and credit card financing. The firm is also among the largest managers of funds invested in private companies.

My responsibilities include assessing the risk profile of CSFB on a global basis and recommending corrective action where appropriate to protect our capital. This objective is similar to many of the goals of bank supervisors, including the drafters of the proposed Basel Accord – to deter large losses and protect bank solvency.

¹ Credit Suisse First Boston (CSFB) is a U.S. financial holding company and leading global investment bank serving institutional, corporate, government and high net worth clients. CSFB's businesses include securities underwriting, sales and trading, investment banking, private equity, financial advisory services, investment research, venture capital and asset management. CSFB operates in more than 89 locations across more than 37 countries on six continents. The Firm is a business unit of Zurich-based Credit Suisse Group, a leading global financial services company.

² The Financial Services Roundtable is a national association representing 100 of the largest integrated financial services companies in the U.S. providing banking, insurance, securities, and investment products and services to American consumers.

The Basel II Capital proposals have been the topic of intense discussion and debate in the financial and regulatory community for the past several years. The industry supports the objectives of the Basel process: to better align regulatory capital to underlying economic risks, promote better risk management and foster international consistency in regulatory standards. The proposed Accord is not a minor refinement to the bank regulatory process, but is, instead, a wholesale reform of bank regulation – a regime that covers roughly \$2 trillion of capital and is a key economic engine for most developed markets. The impacts of these seemingly technical discussions will affect banks, the markets and the economy in a deep way, and this committee is prudent to consider the effects carefully before implementation.

Before I start, I would like to note that I have personally developed tremendous respect for the diligence and stamina of the regulators who have worked on Basel II, as well as the review done by Congress. They have had to address a great many complex and challenging issues, and have been tenacious in trying to develop a "best practice" solution for each. Balancing all of this and applying it to very different financial markets around the world – with political sensitivities in each – does not make this an easy job. I wish to express appreciation for the efforts of Federal Reserve Board Governor Bies and Vice Chairman Roger Ferguson, who have met with CSFB and Roundtable member companies on several different occasions to listen to our concerns on the proposed Accord. The OCC, FDIC and OTS have also had open doors for discussion throughout the long process of developing the new Accord.

CSFB and the Roundtable have worked hard to be constructive commentators on the new rules, particularly in respect to practical implementation issues. The proposal has been continually evaluated and the regulators have demonstrated a willingness to address specific issues raised by industry and academic critics. We support the direction in which the Accord has moved, and appreciate the regulators' willingness over time to reexamine earlier conclusions and consider further changes.

Basel II has considerable momentum, and most people in the industry believe it will likely be implemented in the relatively near future. However, as in all complex undertakings, the Basel document in its current state is not perfect. On balance, we believe that the advantages of the reform substantially outweigh the drawbacks, but further improvements are still possible and desirable.

Today, without getting too involved in the technical details of the Accord, I would like to highlight three issues that we believe are particularly important as the Accord moves forward:

1. The Accord features some recently developed capital treatments for a bank's trading book. We are concerned that some of these new rules – specifically, those dealing with the calculation of a default risk capital charge for trading book positions - have been expressed in fairly general terms to date and are benchmarked against an inappropriate banking book standard. We are hopeful that we can see a memorialization of the verbal guidance already provided by regulators on where they are heading on certain key features. We also hope that the timetable for implementing this new calculation can be separated from the rest of the Accord, to allow for proper impact testing and careful implementation.
2. The regime for cross-border implementation of the Accord is not yet fully transparent. While an Accord Implementation Group has been established to deal with the so-called home-host issues, there has been painfully little tangible guidance, particularly for dealing with regulators in smaller countries not directly participating in the Basel process. The home-host issue with respect to the allocation of operational risk charges across jurisdictions is just one example of the need for greater clarity on cross border implementation. It is also important for the U.S. and the other G10 countries to conduct home-host regulation on a basis of real comity. We cannot afford duplication, waste or needless divergence.
3. The Accord is a complex document and there is a need for flexibility from all regulators if it is to be implemented successfully. Regulators will need to work with each other, as well as regulated institutions, to construct principles-based solutions under Pillar II of the Accord to address developments that don't fall neatly under the black-letter requirements of Pillar I. Regulatory transparency, communication and international coordination are key to this effort, together with continued Congressional Oversight, to ensure that the application of Basel II in practice is consistent with the original principles behind the reforms.

Trading Book Review

The first topic I want to discuss is the recently completed Trading Book Review. For several years now, the discussion regarding Basel II has focused principally on credit risk capital, and this area has been continually reviewed and reshaped based on an open, transparent process. For a combination of reasons, it was recently determined that a separate discussion of capital charges for market risk inherent in the traded credit and equity portfolios would also be necessary. With this in mind, a process was begun last year whereby the regulators and the industry entered into a cooperative dialogue through the BIS and IOSCO to address these issues

Because of the tight timetable, the new trading book proposals involving market risk (referred to as "Strand 3" of the Trading Book Review) have been designed and evaluated over a period of months, rather than the period of years that other parts of the Accord have been subject to. This contrasts sharply with the other "Strands" of the Trading Book Review, such as the work on counterparty credit risk, where the requirements have been subject to extensive development and dialogue with industry practitioners. The first draft on the new trading book standards was seen in April with one round of comment and a final version in July. Not surprisingly, there remain areas where regulators and the industry recognize that continued refinement will be necessary.

During the development stage, regulators have held a number of sessions with the industry to discuss certain problems found in the trading book drafts on market risk and to give the industry comfort in a critical area of the Accord. In these sessions, members of the BIS-IOSCO Working Group provided helpful guidance on their specific intentions related to the draft text. Industry members appreciated this clarification greatly and concluded that the rather general final language could work in practice with the interpretation that they heard directly from senior regulators.

Given the reliance placed by firms on the information provided in these sessions, we believe that it makes sense to record a common understanding of what was communicated. The industry has requested a memorialization of the understandings from the working sessions from the regulators, and we are optimistic that we will see such an affirmation in the relatively near future. We are aware that regulators plan to conduct further work in consultation with industry to flesh out the conceptual thinking in this area, and we are not seeking to pre-empt this review in any manner. However, we do believe that confirmation of the underlying understandings that were publicly discussed will assist regulators, industry associations, and firms to work on the basis of a consistent and clear understanding across firms and across jurisdictions, in accordance with the Working Group's intentions. This will ensure transparency of the regulators' intentions and gives industry participants greater confidence to move forward with the investments required to begin implementation of the trading book standards.

In addition, it is also worth noting that the new trading book requirements have only recently been published and that there remains work to be done to flesh out how they should be implemented in practice. In addition, no comprehensive impact assessment has been performed to date, and we believe this is a key gap that should be closed. We suggest that all regulators take advantage of the existing provision deferring the effective date until 2010 for this section of the Accord, so that refinement, impact analysis and final implementation can be done in an orderly, consistent manner. This timetable could be separate and apart from the rest of the Trading Book Review and the bulk of the final Accord.

Home/Host Country Issues

The second topic I would like to address is the complexity of the new rules, which pose particular challenges for an international bank that is regulated by supervisors in multiple countries. CSFB, for example, will be required to implement Basel II as a Swiss bank, a U.S.

financial holding company, a U.K. bank, and a regulated financial institution in 30 plus other countries. Our implementation will be governed primarily by the Swiss Federal Banking Commission, in conjunction with the Federal Reserve in the U.S. and the Financial Services Authority in the U.K., and also by other regulators around the world.

Most international banks face a similar set of interlocking regulation, in which both home and host countries interpret and enforce rules. This can give rise to conflicts, even under an international standard like the Basel Accord. At times, we have been given conflicting requirements by home and host regulators under Basel I, making compliance a very difficult "Catch-22". While we have been able to resolve these issues to date, the potential tension between "home and host" regulators will become a bigger issue given the much wider and more detailed Basel II regime. If each country decides to require its own local rules and local data for each of the many calculations required under Basel II, the compliance burden will go from bad to worse. The Basel Committee has formed an Accord Implementation Group to deal with cross-border implementation issues, but experience shows that some differences between multiple supervisors are inevitable.

We are pleased to note that U.S. banking regulators have indicated a willingness to accept the Basel II approaches and calculations followed by a bank's home country supervisors, when evaluating an international bank with U.S. branches and for purposes of eligibility of Gramm-Leach-Bliley Act financial holding company status. This is reassuring to hear. We hope that other host countries adopt similar policies that defer to home country regulators, and that similar issues related to subsidiary banks also are addressed.

For large international banks it is imperative that local host supervisors take account of the context of the whole organization. We have seen a tendency for regulators to require capital to be computed according to full Basel II standards in smaller subsidiaries, even though the draft Accord provides leeway and the assets and operating risks of those subsidiaries are consolidated, for Basel II Advanced purposes, at the holding company or parent level.

We believe that stronger proposals should be developed to resolve home/host country conflicts in a timely and more predictable manner. In particular, we believe practical benefits could be obtained by establishing a Committee of leading supervisors to understand large institutions with significant cross-border operations, and to resolve any interpretive problems under the Accord. There may also be some benefit from bilateral or multi-lateral home-host understandings between the U.S. and other national regulators to address specific institutions. We see such an approach today regarding the examination and supervision of a selection of internationally active institutions, including CSFB, and think that this experience can be directly applied to ensure a uniform and consistent implementation of the Accord.

Principles-Based Interpretation

Lastly, one of the critical elements of implementation of the Basel Accord will be the need for flexibility consistent with the concepts outlined in Pillar II of the Accord. The proposed Basel rules are based on the financial markets as they work today, but are so complex and heavily negotiated that they will be difficult to update over time. We strongly believe that regulators ultimately will need to place a renewed emphasis on the principles-based approach that underlies the Pillar II section of the proposed Accord, as a matter of either law or practice. Whereas Pillar I sets out regulatory capital calculations in a detailed, prescriptive way, the approach of Pillar II places a greater emphasis on the examination process and regulatory guidance to improve risk management practices.

This “principles-based” approach, subject to reasonable benchmarks and guidelines to maintain consistency, has some important natural advantages compared to Pillar I’s complex “black-letter” style. Pillar II encourages banks and regulators to work together over time to improve risk management practice, rather than forcing compliance with a potentially dated rulebook. That approach permits steady, evolutionary improvement to keep up with markets,

and should therefore be more durable and relevant than Pillar I rules that are designed with today's markets in mind. That approach should be acknowledged expressly in the final Accord. Pillar II is entirely consistent with the U.S. regulatory and examination process, but it is by no means standard practice in most other jurisdictions around the world. In order to have consistent implementation of the Basel rules across different jurisdictions, it will be critical that the U.S. regulators take an active role in communicating with other national regulators on the cooperative manner under which the Pillar II process will need to operate in practice, as a complement to the literal requirements of Pillar I.

Addressing the question of an evolving Accord over time will not be simple. If the rules are all applied as black letter law and interpreted strictly, the new rules will be both costly and – since the risk management advances that lead in part to Basel II will not end in 2005 – potentially irrelevant to ongoing best practice. One example of this relates to Operational Risk, an area that is relatively new in terms of a risk management discipline and quantification. There is a danger that certain approaches can be mandated as "best practice" by regulators in some jurisdictions, even though development in this area is far from complete. It is imperative we avoid new fixed requirements where they arise solely from the interpretations of the Accord by certain examiners.

We encourage an approach that emphasizes principles and simplicity as the rules are implemented, and a less burdensome "trust but verify" approach to compliance. Specifically, regulators will need to emphasize that compliance with the rules will be based not on "box checking" but with the spirit of the rules, based on economic principles.

Summary

We are at an important stage in the reform effort, perhaps the final leg of a long race. A lot of good hard work on designing the framework and gaining political consensus has been accomplished. We have a high regard for the efforts of the Basel Committee and the regulators who have worked so hard to capture the best current practices in risk assessment. CSFB and the Roundtable have tried to contribute to the specifics of those discussions in a constructive manner, and submit the three proposals we discussed today – trading book review implementation, cross border implementation, and principles based interpretation – in that light. We believe that refinements are still possible and that these changes will help to make the Accord more effective in practice.

As a final comment, I believe that regulators will need to look beyond the detailed calculations embedded in the rules, and focus on the overall quality, thoughtfulness, and integrity of a bank's risk management process to implement the Accord successfully. This places the burden back where it should be – on the shoulders of bank management - to demonstrate to the regulators and the public that they are doing a good job. That is in the spirit of the Sarbanes-Oxley reforms in the United States, and I think it is a smart, durable way to improve financial discipline and live up to the original goals of the Basel project.

Thank you.



Testimony of
America's Community Bankers
on
"Private Sector Priorities For Basel Reform"
before the
Subcommittee on Financial Institutions
and Consumer Credit
of the
Financial Services Committee
of the
United States House of Representatives
on
September 28, 2005
Kathleen E. Marinangel
Chairman, President & CEO
McHenry Savings Bank
McHenry, Illinois
and
Member, Board of Directors
America's Community Bankers
Washington, DC

Chairman Bachus, Ranking Member Sanders, and members of the Subcommittee, my name is Kathleen Marinangel. I am Chairman, President and Chief Executive Officer of McHenry Savings Bank, a \$250 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 testifying today on behalf of America's Community Bankers, where I serve as a member of the Board of Directors and on several committees. Thank you for this opportunity to testify on the priorities of community banks for Basel reform. ACB and its members have taken the lead for some time now in raising issues about Basel II and requesting simultaneous changes to Basel I. ACB has expressed concern about the impact that Basel II will have on community banks from a competitive perspective, as well as what effect the Accord will have on consolidation and merger activity in the financial services sector. We also have expressed concern about the complexity of the proposal and the impact it could have on the safety and soundness of the U.S. banking system.

We believe that the development and implementation of the Basel II Accord is one of the most important regulatory initiatives for community banks today. The U.S. financial regulators intend to implement Basel II in a manner that will for the first time create a bifurcated regulatory capital framework in the United States. As currently contemplated, only about 10 banks 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. All other banks and savings associations would remain subject to Basel I. This proposed implementation strategy and the results of the most recent quantitative impact study for Basel II show the importance of Congressional oversight over this process.

I would like to make two important points at the outset of my testimony. U.S. bank regulators will be attending the regular quarterly meeting of the Basel Committee on Banking Supervision next week. Our understanding of the process in Europe is that the European Parliament plans to move ahead on Basel II implementation and because of the unique governmental structure created by the EU, legislators feel they must make some decisions about the specifics of the new capital requirements fairly soon. Because the European framework provides limited flexibility to make changes to Basel II in the future once these final decisions are made, European banking supervisors are pressing for agreement as to specifics on Basel II. We believe strongly that the U.S. regulators should make no commitments to their foreign counterparts next week in light of the still evolving nature of Basel II implementation in the United States. As our regulators continue to review the results of the most recent quantitative impact study, they need the flexibility to make changes to Basel II as circumstances dictate to ensure the safety and soundness of the U.S. banking system as well as to maintain a level competitive playing field.

While we understand that there needs to be coordination and cooperation with European counterparts to the extent possible, no legislative or regulatory process in the European countries should dictate the timing of how the U.S. regulators proceed here in the United States.

The other point I would like to make is to commend the U.S. financial regulators for initiating a dialogue with representatives of the banking industry about developing a Basel Ia for the institutions that will not be subject to Basel II. The industry had a very productive meeting with regulatory staff back in July to discuss the revision of capital requirements. The industry was able to provide helpful information to the staff about the influence that capital requirements have on an institution's business strategy and the kinds of changes that could make Basel I more risk sensitive without adding too much regulatory burden. We found the staff very willing to listen to the industry's perspectives. Our understanding is that the regulators will soon issue an Advance Notice of Proposed Rulemaking to solicit additional information and comment on proposals to revise Basel I.

It is vital that the federal financial institution agencies continue to work on the development of a Basel Ia that provides more risk sensitive capital requirements for those United States financial institutions that cannot or are not permitted to comply with Basel II. We also believe that as Basel II implementation and Basel I revisions move forward, it is essential for Congress to remain engaged and to play an active role, as this committee is doing so ably. Nothing could be more important to the future of the U.S. banking system than the capital requirements necessary to ensure the safety and soundness and economic health of the banking industry and, in turn, the broader economy.

Basel II Accord

Let me turn to a discussion of the Basel II Accord and ACB's concerns and position. ACB does not oppose implementation of Basel II. As we testified before the Subcommittee on Financial Institutions and Consumer Credit last spring and before that almost a year ago, we support the efforts of U.S. and global bank supervisors to more closely link minimum capital requirements with an institution's risk profile. This approach could increase the safety and soundness of the banking industry and allow institutions to deploy capital more efficiently.

We do have significant concerns about the complexity of the proposal and the ability of financial institutions to understand and implement, and supervisors to adequately administer and enforce, the proposed new capital requirements. Although the current version of Basel II is less detailed than previous versions, it remains extremely complex. Because adequate capital is so important to the global financial community, the inability to properly implement, supervise and enforce capital requirements can lead to significant safety and soundness issues.

Therefore, we believe that prior to adoption, legislators, regulators and the industry need to evaluate the complexity of the proposal and the ability to monitor compliance. More examination needs to be made into the real-world consequences of adopting an extremely complicated capital regime, including the resources needed for implementation, the problems inherent in on-going maintenance, the likelihood of effective regulation and market oversight,

and the competitive pressures that could encourage banks to game the system.

We understand that the U.S. regulators currently propose to leave a leverage requirement in place. We believe that a regulatory capital floor must remain in place to mitigate the imprecision inherent in internal ratings-based systems. However, the precise level of the leverage requirement should be open for discussion. Institutions that comply with Basel II, and possibly institutions that comply with a more risk-sensitive Basel Ia, may not achieve the full benefits of more risk-sensitive capital requirements because they may push up against the leverage ratio requirement. In order to avoid this result, absent changes to the ratio, these institutions may make balance sheet adjustments based solely on capital requirements rather than on the best interests of the business. Also, we are concerned that these institutions might look to move assets off the balance sheet as a way to avoid capital requirements. These would not be good outcomes. Therefore, it may be necessary to revise the level of the leverage ratio or the manner in which it is calculated.

Competitive Concerns

In the years since the adoption of the Basel I Accord, the ability of all financial institutions to measure risk more accurately has improved exponentially. That ability to measure credit, interest rate, operations, market and other risks is the basis for the changes that will be part of the revised capital requirements. Unfortunately, the complexity and cost of development, implementation and supervision of the models needed to measure and evaluate the risks likely will preclude all but a small number of banks in the United States from taking advantage of the more risk sensitive capital regime proposed in Basel II.

Capital requirements should treat similar risks comparably from institution to institution to avoid creating competitive inequities, and must maintain adequate capital cushions. Last spring, the banking regulators reported that the most recent quantitative impact study conducted to measure Basel II's impact in the United States showed evidence of significantly large reductions in the aggregate minimum required capital for participants in the study and significant dispersion of results across institutions and portfolio types. The results show that capital requirements for mortgage loans could drop by more than 70 percent for some organizations. There are steep drops for home equity loans and other consumer lending products as well. These results have forced the banking agencies to do additional analysis of the study and delay publishing a notice of proposed rulemaking to implement Basel II.

The U.S. study confirmed the results of prior global impact studies performed by the Basel Committee on Banking Supervision that showed the new accord resulting in significant capital savings for some of the largest banks and savings associations in the United States and other countries. These large institutions compete head-to-head with community banks in the retail area, including my bank. Retail lending, particularly residential mortgage lending, is a fundamental business of community banks.

The Federal Reserve Board has released the results of separate studies on the competitive impact of Basel II on small and medium-size business loans and mortgage loans. It also studied the

impact Basel II could have on consolidation of the industry. While the studies are well intentioned, we do not necessarily agree with their conclusions. Any studies of this type are often conducted with a lack of perfect data and the need to employ assumptions that may or may not be correct. We also believe that these studies were premised on the assumption that Basel II would primarily affect distribution of capital among large institutions, but would not have material effects on overall capital in the system. The results of the quantitative impact studies show demonstrably that this is not the case. The fact is that no one can really know with certainty what the competitive impact of a bifurcated system will be at this point in time.

The best available evidence suggests that Basel II will open the door to competitive inequities. Under a bifurcated system, two different banks, a larger Basel II bank and a small Basel I community bank, could review the same mortgage 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 we believe that capital requirements play a part in the pricing of loan products, that community bank may not be able to offer the same competitive interest rate offered by the larger institution. This cannot be the right result or the desired result. Capital requirements should be a function of risk taken, and if two banks have very similar loans, they should have a very similar required capital charge. Although some community banks may choose to have capital levels higher than required by regulation, that is a choice that might be made for various legitimate business reasons, and is not a justification for leaving in place higher capital requirements for the same types of lending.

We are concerned that unless Basel I is revised, smaller institutions under a bifurcated capital regime will become takeover targets for institutions that can deploy capital more efficiently under Basel II. For instance, if I could acquire another bank's assets at a fraction of the required capital ratio imposed on that bank, I 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 would drive acquisitions that otherwise would have no economic purpose. Another important factor for publicly held community banks is the need for them to leverage their capital to maintain a sufficiently high return on assets for their shareholders in order for them to remain independent. And unless Basel I is revised, the smaller banks that survive as stand-alone entities will find it more costly to compete for quality assets and may be forced to operate with higher risk assets in order to provide competitive pricing.

Community banks must retain the option to leverage their capital, regardless of the complexity of the calculations, to improve their ability to manage risk. They must be given the choice to opt in to Basel II or comply with a revised, more risk-sensitive Basel I to compete against the international banking giants. ACB is pleased that the bank regulators appear to agree and have committed to revising Basel I to be effective along the same timeframe as implementation of Basel II.

Creation of Basel Ia

As I explained above, the bank regulators have committed to reviewing Basel I and issuing an

Advance Notice of Proposed Rulemaking addressing possible changes to the framework (creation of a Basel Ia) as early as next month. For the reasons stated in this testimony, ACB strongly believes that Basel I must be revised to have more risk sensitive options at the same time as Basel II moves forward. This is essential if the United States is to maintain similar capital requirements for similar risks and not disadvantage the thousands of community banks not eligible to participate in the new capital plan.

ACB believes that any financial institution that has the resources should be able to voluntarily comply with Basel II if its management and the Board believe it is in the institution's best interests. There should not be any constraints on which institutions have the choice to opt in. However, for those institutions without the significant resources needed to meet the very stringent qualification requirements, an opportunity to have alternative, more risk-sensitive capital requirements should be available.

ACB has advocated in its letters to the banking regulators and in previous testimony before this Subcommittee that the current capital regime which is based on Basel I should be amended to take advantage of the ability of institutions and supervisors to measure risk more accurately. The purpose of these changes would be to alleviate some of the disadvantages for community banks that ACB and others believe will develop with the implementation of Basel II for the largest banks.

The current system requires banks to carry far more capital than they need, because it fails to consider such factors as the loan-to-value ratio of retained mortgage portfolios, collateralization of commercial loans, and banks' significant nonfinancial assets. 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 US banks will have to comply with the current crude risk measurement, unless Basel I is amended. Currently, 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. It is clear that the risk is not the same. A revised Basel Ia could include more baskets and a breakdown of particular assets into multiple baskets to take into consideration collateral values, loan-to-value ratios, and credit scores. Credit mitigation measures, such as mortgage insurance and guarantees, could be incorporated into the framework and other revisions could be made to further refine current capital requirements. Such an approach would be relatively simple for banks to implement and for regulators to supervise.

Bank regulators could also adopt a simplified risk-modeling approach that is consistent with the less complex operations of most community banks. The modeling approach would establish capital levels that more clearly reflect each institution's actual risk levels without adding the significant costs of implementation required of the more sophisticated approaches in Basel II. A simplified modeling approach could be developed by the regulators for use by the industry, much like the Office of Thrift Supervision has developed interest rate risk models that are now used by savings associations. It also is likely that third party products and services would become available to assist institutions in adopting a simplified internal ratings system, subject to regulatory review.

We also believe that the smallest of community banks should have the option of continuing to comply with Basel I as it is currently constituted. There are many smaller institutions that hold capital in excess of minimum requirements and will continue to do so after Basel II is implemented. These institutions often operate in small communities and do not face the same type of competition from the larger Basel II banks that is faced by community banks in more urban and suburban areas. These smaller institutions should not have to deal with the increased regulatory burden of changed capital requirements if they would prefer to remain compliant with a less risk-sensitive Basel I.

The bank regulators have listened to our comments and suggestions and are moving forward to improve Basel I. ACB will continue to be actively engaged in this process and is willing to assist the regulators in any way we can to develop a reasonable approach.

Conclusion

In conclusion, ACB does not oppose the implementation of Basel II in the United States but we believe that more examination is needed into the ability to implement the proposal adequately and the competitive impact of a bifurcated capital system. Revisions to Basel I must be made to recognize the lower level of risk of retail loan products (particularly mortgage loans), more accurately reflect the true risks in community bank portfolios, and lessen the unintended competitive impact of Basel II. In order for this to happen, U.S. regulators should make no commitments to their European counterparts during their upcoming meetings on Basel II.

I wish to thank Chairmen Bachus, Ranking Member Sanders and the rest of the Subcommittee members in giving ACB this opportunity to present our views. As I mentioned at the outset, there is no more important issue to community banks than the development and implementation of Basel II, as well as long overdue changes in Basel I requirements.

TESTIMONY

Next Steps for the Basel II Rules

**Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.**

**Before the
Financial Institutions and Consumer Credit Subcommittee
Committee on Financial Services
U.S. House of Representatives**

September 28, 2005

It is an honor to appear again before this distinguished Subcommittee to review the status of the Basel II rulemaking and its implications for U.S. financial services firms, their customers and the economy as a whole. I am Karen Shaw Petrou, managing partner of Federal Financial Analytics, a consulting firm that has worked for a variety of clients on the Basel II Accord. We also advise the Financial Guardian Group, which focuses in particular on the operational risk-based capital provisions.

Your Subcommittee and, indeed, the Financial Services Committee, has done on this issue what is often so difficult: anticipate a problem instead of just responding after one occurs. The Basel II rules are especially formidable because of their complexity – not to mention all their math. Thus, it would have been tempting to consign this issue to the regulatory agencies and hope they work out an agreement among themselves.

Congressional leadership is, though, critical to ensure that such an agreement – important and desirable as it is – looks not only at the Basel II details, but also at broader safety-and-soundness, competitiveness and customer-service implications.

As you know, the U.S. has a big decision before it: whether next month to tell all of the other nations in the Basel process whether we can agree to the final Accord and, if so, when we will implement it. The agencies are also completing an advance notice of proposed rulemaking (ANPR) on “Basel IA,” revisions to the Basel I rules that would apply to some or all of the banks and savings associations outside Basel II. In my view, the current state of affairs has placed the U.S. in a “damned if we do, damned if we don’t” position – the most awkward of all, of course.

If the U.S. tells Basel we are in, we will buy into a complex rule with, at last count, a 50-page list of provisions subject to “national discretion.”¹ Further, we will buy in even as we propose to keep our unique leverage ratio and apply Basel II only to the very largest institutions. Thus, in the name of a common international prudential framework, we will accept one that is in fact quite different in each implementing nation, with the U.S. taking a particularly independent tack. Of course, we still aren’t even sure what the rule’s impact will be here, given the quixotic results of the fourth quantitative impact study. In essence, we will be putting the round-peg of the U.S. financial system through the Basel II square hole.

On the other hand, though, are the adverse consequences of not buying in to Basel II. Like it or not, ready or not, the framework is final everywhere but here. This means that banks around the world are about to get risk-based capital standards that, while far from perfect, are a whole lot better than those that would continue to govern U.S. banks and savings associations. Many big institutions are working hard and spending millions to adopt new, improved capital measures, measures that will make them safer as well as ensure ongoing competitiveness with banks in the European Union, Japan, and Canada. Banks trying to decide whether or not to opt in to Basel II are caught in a particularly tough dilemma because they don’t know into what they are opting and what their IA options may be, stalling attempts to improve their capital allocation. On top of this, it is most unclear how the EU will treat U.S. banks that aren’t subject to Basel II rules at home.

¹ Consultation Paper 05/03: Strengthening Capital Standards, Financial Services Authority, January 2005.

In short, current plans for Basel II in the U.S. won't work, but it is at the same time also imperative that our regulatory capital standards change as quickly as possible. I would like to use this statement to suggest a way out – a way out in which Congress, by continuing its push for regulatory consensus – will play a very important role. Next steps to resolve this dilemma include:

- There should be quick U.S. implementation of the standardized credit risk-based capital provisions in Basel II. These are particularly appropriate for specialized banks with small portfolios of high-quality assets. Regulatory capital for high-risk assets must go up at all banks and similarly go down for low-risk assets at all banks. Half-way measures will leave big risks unaddressed and create serious competitiveness problems. Deferring the standardized options now in hopes of eventually implementing the better advanced options is a classic case of making the perfect the enemy of the good.
- We should pair this with immediate revisions to the leverage rule for banks and savings associations coming under these revised standards so that the leverage standard does not create a perverse incentive to take undue risk. Keeping leverage as is under the Basel II plans will also worsen small-institution competitiveness problems because they will find it harder to game the leverage requirement.
- It is essential that the regulators implement a new supervisory framework (Pillar 2) for operational risk without a mandatory regulatory capital charge (Pillar 1). A regulatory charge for operational risk now will create perverse incentives against readiness for natural and man-made disasters, as well as pose unique and significant competitive problems for U.S. banks.
- We must continue to work quickly to finalize the advanced approaches for credit and operational risk. Importantly, big investment banks in the U.S. can come under the current Basel II advanced options without a leverage requirement at the same time as foreign institutions, putting large U.S. banks in a potentially big competitiveness hole if advanced options are not quickly made available to them as well.

The Basel Conundrum

As noted, the Basel II framework is now final everywhere else but here. This summer, the last remaining piece – capital standards for counterparty credit risk and the trading book – was concluded by the Basel Committee. Now, national supervisors – again, everywhere but here – are going through the packages to decide where to exercise all the national discretion noted above.² Thus, the final Basel framework is dictating implementing rules that will look a lot different as one moves across national borders. This has led to a lot of work on “home-host” coordination – that is, finding a way to minimize all these differences so that the standards do not pose barriers to entry or create undue cost and complexity. A lot of work remains on all of these issues, and it is critical to ensure that Basel II does what its authors intend. Still, despite all this important effort, the Basel II gig is up – again, everywhere but here.

In her testimony before this Subcommittee in May, Federal Reserve Governor Susan Bies rightly noted that Basel II implementation around the world could put U.S. banks at a competitive disadvantage.³ My testimony at that time went into considerable detail on this point that I will not repeat here.⁴ Suffice it to say, however, that – starting January 1, 2007 – large, global financial services firms will have sharply lower risk-based capital (RBC) on mortgages, small-business loans and many other assets important in their U.S.

² *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects*, The Basel Committee on Banking Supervision & the International Organization of Securities Commissions, July 18, 2005.

³ *The Basel II Accord and H.R. 1226*, Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology and the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives, May 11, 2005.

⁴ *Basel II Regulation: U.S. Market and Competitiveness Implications*, Testimony before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology and the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives, May 11, 2005.

operations. Back in their home countries, foreign banks do not have a leverage ratio and they also consolidate capital from all of their operations to determine Basel II compliance. Thus, the high Basel I capital charges applied to their U.S. loans will be offset by reductions where Basel II applies.

This could well make these banks capital powerhouses, putting them into the merger-and-acquisition (M&A) business with a bang. With barriers to entry remaining high within the EU and in most other nations, EU and Canadian banks – possibly soon joined by newly-strengthened Japanese ones – will look to the U.S. for new targets. Further, as noted, big U.S. investment banks will also come under Basel II. The SEC has created a “consolidated supervised entity” (CSE) charter for these institutions, giving them comparable market power, albeit at a lower capital charge than would be imposed on banks and their parent holding companies.⁵

In my view, it is critical that M&A transactions should proceed based on market efficiencies, not regulatory arbitrage advantages. That is, government action should be neutral with regard to who buys whom, leaving this solely to the market. If the U.S. keeps Basel I for banks and savings associations, they will be unduly vulnerable to foreign and non-bank acquisition. This will increase the number of large, complex financial institutions outside U.S. banking prudential regulation, perhaps increasing systemic risk and surely lengthening the distance between corporate headquarters and the home-town consumer.

⁵ *Final Rule: Alternative Net Capital Requirements for Broker-Dealers that are Part of Consolidated Supervised Entities*, Securities and Exchange Commission, June 15, 2004.

Applying Basel II in the U.S. to the largest banks just adds to the number of possible bidders for smaller U.S. institutions without addressing the systemic-risk and customer-service concerns raised by more consolidation. Going back to your hearings in 2003, I have focused on the adverse competitive impact in the U.S. if Basel II is implemented for big banks and savings associations while all others stay under Basel I. The agencies have begun to address this with the pending Basel IA proposal, but its content remains unclear. Thus, Basel IA is a long way off even as Basel II goes final everywhere else – potentially leaving only Basel I as the capital rules for an unknown period of time for all U.S. insured depositories and most of their holding companies.

The Standardized Solution

Let me say at the start that the “standardized” options in the final Basel II Accord are far from perfect. One major problem is that they include a simple capital charge for operational risk. This is a very troubling and flawed provision and it absolutely should not be included in U.S. capital standards. The standardized Basel II options for operational risk – risks related to computer errors, lawsuits, and natural or man-made disasters – is based on a flat percentage of a bank’s gross income. Gross income, though, has nothing to do with operational risk. In fact, the lower it is, the more risk a bank may well be running even though its standardized operational risk capital charge goes down. At the same time, this new charge is a new cost, leaving fewer resources for essential disaster preparedness and contingency planning. The Federal Reserve on September 22

noted that banks in the Katrina-devastated area generally did a good job on these critical tasks, and it is thoroughly unclear what an operational risk charge would have done except to make this harder.⁶

Apart from operational risk, though, the standardized Basel II option is a reasonable approach to improving the RBC for credit risk. Now, it focuses on unexpected loss, resolving one serious prior flaw. It creates a positive incentive for using credit risk mitigation and holding reserves – important disciplines for improved safety and soundness that should be rewarded. Most importantly, RBC for credit risk goes up as well as down – thus better aligning regulatory capital with economic reality.

The standardized option is the one effective on January 1, 2007 for banks everywhere but here. Under it, low-risk mortgage RBC goes to a 35% risk weighting and consumer and small-business loans go to 75%. These are big drops from the RBC requirements under Basel I that now might stay in place here for years past the Basel start-date. Conversely, high-risk assets will see their RBC weightings go to 150% or higher, but comparable discipline will not apply here because U. S. banks will stay under Basel I (with a maximum 100% weighting) unless or until all our Basel II debates are resolved. Thus, U.S. banks with low-risk books will be at a competitive disadvantage to comparable banks abroad, while high-risk ones here will remain all too free of appropriate risk-based capital.

⁶ SR Letter 05-17, *Katrina Related Marketing Practices Invoking the Name of the Federal Reserve*, Federal Reserve Board, September 22, 2005.

Is the standardized model complex? Yes, but not so much so that even small banks can't use it. Small banks and savings associations with simple portfolios can quickly look through the standardized requirements and implement them without complications the requirements dictate for more complex banks. The biggest – and surely correct – criticism of the standardized option is that it is too crude and keeps RBC too high, but these flaws make it a good starting place for a gradual evolution to true RBC based on tested internal models.

Lower the Leverage Requirement

In the wake of the fourth quantitative impact survey (QIS4), U.S. regulators expressed deep qualms about Basel II because RBC at big banks dropped dramatically and – worse – inconsistently. The inconsistencies were in large part due to significant differences in the way each bank's internal models work – a problem that doesn't apply to the standardized option noted above because it relies solely on regulatory formulas. Under the standardized option, though, lower-risk banks and savings associations would still see at least some of the RBC drops uncovered in the QIS4 exercise, and this has led some of the agencies to toughen their calls for continuing the unique U.S. leverage requirement.

The leverage requirement imposes a simple percentage of regulatory capital against all on-balance sheet assets, regardless of their riskiness. Current law mandates that U.S. agencies set leverage ratios to define which insured depositories are “well” capitalized and which meet all the other “prompt corrective action” thresholds that carry both

supervisory benefits and, for under-capitalized institutions, major penalties.⁷

Importantly, though, the law only defines specifically what leverage ratio must apply to “critically” under-capitalized banks – that is, institutions that should be shut down. This leaves the regulatory agencies a lot of flexibility to reduce the current leverage ratio defining well-and-adequately-capitalized banks and – better still – to stipulate leverage ratios that apply to insured depositories based on their overall risk profile.

If the current approach to leverage is kept, banks can make their regulatory capital better coincide with their economic risk by one simple expedient: moving assets from on- to off-balance sheet status. Once, this was a complex exercise – the reason why current leverage ratios apply only to on-balance sheet holdings. Now, though, it’s easy, with a range of securitization and even “synthetic” instruments available to hold risk off the balance sheet. These tools are, of course, easier for big institutions than small ones. Thus, keeping the leverage ratio in place as is will exacerbate the competitiveness problems smaller institutions rightly fear if U.S. plans for implementing Basel II remain unchanged.

There’s one other way banks can align RBC with economic risk and still comply with the current leverage standard: they can simply “top up” their balance sheets with very high-risk paper. This can make their total capital numbers make sense on both the regulatory and economic fronts. Of course, this also creates a perverse incentive for banks to add a layer of toxic assets to books that would otherwise be free of them –

⁷ 12 U.S.C. § 1831o.

hardly the incentive towards improved safety and soundness at which all of Basel II is rightly aimed.

Next Steps in the U.S.

Nothing here is intended to downplay the advantages of the advanced approaches to both credit and operational risk. It is, rather, to argue for an incremental implementation strategy that puts in place as binding regulatory capital standards only those known to make sense from both a prudential and competitiveness point of view. The U.S. can and should move quickly to the advanced Basel II options, but quickly means only at the pace at which all institutions that wish to pursue Basel II – not just the biggest banks and savings associations – demonstrate readiness for rules regulators should continue to test and adapt.

Outside the U.S., implementing the advanced Basel II options on the planned schedule – January 1, 2008 – has fewer potential adverse consequences than doing so in the fashion now planned for the U.S. First and foremost, non-U.S. banks do not have the leverage requirement, so the full benefit of Basel will be achieved over a short period of time for many entities. Further, all commercial and investment banks, as well as investment advisers, will come under Basel II, ensuring level competitive consequences; under U.S. law, the banking agencies can impose Basel II only on insured depositories and some – far from all – of their parent holding companies. Finally – and perhaps most importantly – failure to meet regulatory capital has far fewer consequences outside the U.S. Here, it

means a sudden and sharp halt to business as usual for any bank that falls below the well-capitalized threshold, let alone all the still more harsh sanctions that apply to those that fall below the capital requirements.

Thus, I would suggest the following approach to implementing Basel II in the U.S.:

- quick action on Basel IA so that banks can make a reasoned decision about which capital regime makes sense for them. Now, regulators are demanding to know whether mid-sized banks will opt in to Basel II, but this is a choice between a rock and no place unless or until the Basel IA option is clearer;
- final action on the Basel II standardized credit risk option as quickly as possible so that the rule is in place as close to the January 1, 2007 start date as possible. All institutions, regardless of size, could choose to come under this option, with the largest required to do so if desired. A revised leverage requirement applicable to all institutions under this option should be imposed simultaneously;
- consideration through public notice and comment of a revised approach to the Basel II advanced options so that the U.S. rules reflect U.S. reality. This should include a revised leverage ratio, full recognition of reserves in the credit risk-based calculation and an economic – not regulatory – capital allocation for operational risk comparable to the one now in place for interest-rate risk. Capital definitions should be revised to reflect U.S. tax law and provisions addressing insurance and other forms of risk mitigation should similarly reflect the real world in which these protections have proven track records; and
- final action on a U.S. version of Basel II that can be pursued by any and all institutions. Regulators should carefully review the incentives created by Basel IA and II to ensure that institutions do not pick their RBC regime based on inappropriate risk-taking incentives, with sanctions built into the rules to reflect this. Until Basel II is tested through an entire business cycle, strict attention must be paid to stress testing, with sanctions also applicable when institutions fail to do this right. Over time, regulators should consider moving to a system in which banks set their RBC based solely on internal models and regulators harshly sanction them when these models fail, but this step should be delayed for the years it will take a more incremental approach to risk-based capital to prove itself from both a prudential and competitiveness perspective.

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**Basel II Capital Accord:
A Guide for the Perplexed**

By

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September 21, 2005

**Basel II Capital Accord
A Guide for the Perplexed**

Introduction

The Basel II Capital Accord is facing its moment of truth. The Accord, which is scheduled to be implemented by January of 2008, will affect, directly or indirectly, the entire banking industry, including regional and community banks and savings institutions, and could result in fundamental changes in the number, size and business lines of all types of depository institutions. It could also have a significant impact on the availability and cost of credit for the entire economy. As a result, the Accord has become a subject of controversy among the banking agencies, Congress, the financial services industry and academic experts. This paper provides information on why the Accord was developed, the essential changes that it makes in capital policy, and the arguments for and against the proposal. It also offers some suggestions for implementation of the Accord that will mitigate some of the concerns raised with the current plan.

The Current Basel Capital System

In the early 1980s the world's banking system was in crisis. Capital levels of major international banks were deteriorating. At the same time, the risks associated with cross-border banking were increasing, and concerns were expressed that the debt load of many of the developing countries was too excessive. In fact, in 1982 Mexico announced that it was unable to repay its foreign debt obligations, and a group of 17 highly indebted countries asked for concessions on their loan terms.

In light of these developments, the central banks and other bank supervisory officials from the leading economic powers met in Basel, Switzerland to formulate a plan to enhance bank capital. The Basel Committee¹ determined that the best way to strengthen capital and to reduce competitive inequalities was to formulate a uniform international capital standard that reflected the riskiness of the institution's assets, including off-balance sheet assets (such as guarantees and long-term loan commitments). In July 1988, a capital framework was approved by the members of the Committee and implemented by the individual countries represented on the Committee, as well as other countries. This standard is now referred to as Basel I.² Under Basel I, a bank's assets are assigned one of four risk weights or baskets, ranging from 100 percent to 0 percent, and a capital charge is assessed on the risk-adjusted value of the asset. For example, a commercial loan is risk-weighted at 100 percent and a residential mortgage loan is

¹ The Basel Committee was originally formed in 1974 by the Central Banks of the Group of Ten - the major industrial countries that are members of the IMF. The Basel Committee consists of Central Bank and banking supervisors from the Group of Ten, plus Spain and Luxembourg.

² Since its issuance in 1988 it has been amended on several occasions, for example in 1995 to take into account the beneficial effects of netting provisions, in 1996 to recognize the need to hold capital for market risk, and in 2001 to change the capital treatment of residual interests and direct credit substitutes.

risk-weighted at 50 percent. Thus the minimum capital ratio of 8 percent requires \$80 of capital for a \$1,000 commercial loan, but only \$40 of capital for a \$1,000 residential mortgage loan.

Origins of the New Capital Framework

It is widely recognized that the original Capital Accord significantly strengthened the capital levels and safety and soundness of the banking system, and helped provide competitive equality among banks operating internationally.³ However, by the late 1990s the original Accord was also viewed as a rather crude instrument for setting risk-based capital levels. For example, all commercial loans are placed in the same risk-weighted basket, despite considerable differences in the creditworthiness of the counterparties. Basel I also creates incentives for a bank to securitize its best assets and to hold in portfolio riskier assets within the same risk-weighted basket. Finally, the Basel I framework does not encourage the use of risk mitigation techniques.⁴

In response to these and other perceived weaknesses, the Basel Committee proposed a new capital framework in June 1999.⁵ Following a public comment period, and several revisions, this framework evolved into the Basel II Accord that was agreed to on June 26, 2004, and is now being implemented internationally. The main objectives of the new proposal are to make capital requirements more risk sensitive, encourage institutions to improve their risk management techniques, incorporate more fully off-balance sheet risks, and enhance competitive equality among institutions operating internationally.

Basel II Basics

The Basel II Accord envisions a three-pronged approach to enhancing the safety and

³ AA New Capital Adequacy Framework, \cong Consultative paper issued by the Basel Committee on Banking Supervision (June 1999).

⁴ *Id.*; See also: Statement of Roger Ferguson, Member of the Board of Governors of the Federal Reserve System, Before the Senate Banking Committee (June 18, 2003); FDIC Staff Study, "ABasel and the Evolution of Capital Regulation: Moving Forward, Looking Back." (January 14, 2003).

⁵ *Id.*

soundness of financial institutions: (i) new capital standards; (ii) enhanced supervision; and (iii) increased market discipline through additional public disclosures.⁶ Most of the attention has focused on the first pillar, the new capital standards.

With respect to capital, the Accord permits depository institutions to adopt one of two methods for risk weighting of assets: the standardized model or the internal ratings based (IRB) model. In the United States however, only the internal ratings based model will be used.

The standardized model is easier to apply and closer in approach to the existing Basel I framework. Under the standardized approach, risk weights are assigned to assets based on the credit rating the counterparty (or the asset) has received from an independent third party rating agency, such as Standard and Poors. For example, a loan to a corporation that has an S&P credit rating of AAAA would be assigned a risk weight of 20 percent, while a loan to a corporation with an AA rating would be given a risk weight of 50 percent. On the other hand, if the counterparty has a credit rating below ABB-A the risk weighting would be 150 percent. The standardized approach would assign a risk weight of 75 percent to a portfolio of retail loans to individuals or small business. Prudentially underwritten residential mortgage loans are assigned a weight of 35 percent. The standardized approach also provides beneficial capital treatment of loans that are collateralized or protected by enforceable guarantees.

As mentioned, the standardized approach will *not* be used in the United States. Instead, the U.S. bank regulatory agencies will institute the internal ratings based or IRB model. This is a much more complex system that requires banks themselves to determine required capital, based on the criteria and formulas contained in the framework.

Under the Accord, there are two alternative IRB models, a foundation and an advanced (A-IRB). The foundation model relies heavily on risk data inputs provided by the agencies, with limited computations required by the banks. However, in the United States the foundation model is not being proposed, and instead institutions using the Basel II standards will be required to use the advanced model.

Under the advanced internal ratings based (A-IRB) approach each covered bank must determine specified key data or inputs for its wholesale and retail exposures and equity holdings. The data that the bank must compute includes: (i) the probability of default (PD); (ii) the probable loss to the bank if a default occurs (LGD); (iii) the bank's exposure at default (EAD), for example, the estimated outstanding loan balance at the time of default; and (iv) for certain loans, the maturity of the exposure at default (M). For retail credits, the bank would determine

⁶ Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, (June 2004).

the required data for pools of loans with similar risk characteristics, rather than on a borrower-by-borrower basis. After the bank determines these inputs, the Accord provides mathematical formulas for determining the amount of capital necessary to cover the bank's exposure. Other rules would be used to provide a capital requirement for securitized and off-balance sheet assets.

In determining the required inputs, banks are required to meet minimum supervisory standards. While these standards have not been finalized, certain key requirements have been identified. For example, the bank would be expected to have adequate data to support its ratings and to continually monitor and validate the accuracy of these ratings. Bank requirements are expected to include compiling at least a five-year history of data relating to loans and other assets, and possibly longer if a period of stress for a particular class of borrower occurred prior to the five-year period. Some data will be obtained from external sources, while other information will need to be generated from the bank's own experience.

Operational Risk

In addition to credit risk, the Accord requires covered financial institutions to hold capital to protect against operational risk, which is the risk to an institution presented by its normal operations, e.g. the risk that a natural disaster will disrupt business, that a computer system will fail or malfunction, that an employee will violate a fiduciary duty, or that the bank will be the victim of internal or external fraud. It also includes the risk posed by litigation and failure to comply with regulatory mandates.⁷

The Basel II Accord provides alternative means for computing a capital charge for operational risk. The basic approach simply requires a bank to hold additional capital equal to 15 percent of the bank's average gross income for the previous three years. The standardized approach divides a bank's activities into eight business lines, and then establishes a capital charge for each business line equal to a fixed percentage (ranging from 12 to 18 percent) of the average gross income from each line. The advanced measurement approach or AMA requires each covered bank to establish an operational risk capital charge based on its own calculation of risk. Only the advanced approach will be used in the United States.

In order to use the advanced approach, the financial institution would have to meet regulatory standards relating to the institution's management and oversight of its operations. The bank must also undertake a comprehensive identification and measurement of its operational risk and compile historical data on operational risk losses, both internal and external. Finally, the institution will be required to determine an amount of capital that would be able to cover potential losses due to operations with a 99.9 percent level of confidence.⁸

⁷ The 2004 Accord defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk. (2004 Accord, par. 644)

⁸ One commentator estimates that U.S. financial institutions would have to hold as much as \$67 billion in

Mandatory and Opt-In Banks

The U.S. banking agencies have stated that only two groups of institutions will be subject to Basel II Capital: mandatory or core banks and opt-in banks. The mandatory banks include banks with total banking assets in excess of \$250 billion and banks with total foreign exposures in excess of \$10 billion. Opt-in banks are those banks that voluntarily wish to become subject to Basel II, and have the resources and technical capability to comply with its requirements. It is estimated that approximately ten institutions will be subject to mandatory coverage.

Arguments for Basel II

Supporters of Basel II argue that it more accurately measures the risk of large financial institutions and better captures many of the complex transactions and activities of these institutions. The new system provides capital incentives for depository institutions to hold higher quality credits, and negates the benefits of financial strategies designed to remove high quality assets from a bank's books in order to obtain capital relief. By more closely aligning regulatory capital with the risk posed by an asset, the cost of credit will more accurately reflect the economic cost to make the loan. Thus, for lower risk loans, such as home mortgages, banks and savings associations will be able to reduce the cost of the loan to the consumer. Basel II also permits financial institutions to benefit from the latest techniques in risk management and statistical analysis, and encourages financial institutions to utilize state of the art risk management techniques if they are not already doing so. Finally, in light of the fact that the major economic powers worldwide will be implementing Basel II for their internationally active financial institutions, failure to implement the new Accord for our institutions will place them at a significant competitive disadvantage when in the global marketplace.

Concerns With Basel II

Opponents of Basel II argue that the new standard is overly complex and too prescriptive. Opponents note that the required methodology is not necessarily the best approach for all covered banks, and that it does not always comport with the bank's own internal models. Assessing a capital charge for operational risk is viewed as inappropriate in light of the difficulty in quantifying these risks, and the lack of methodology for obtaining meaningful results. As an alternative, it is recommended that operational risks be dealt with in the supervisory process rather than through a capital charge. Concerns have also been raised that the new system will have the effect of lowering the capital cushion for many institutions thereby undermining prompt

additional capital to comply with the operational risk requirement. See, Karen Shaw Petrou, "Basel II Regulation: U.S. Market and Competitiveness Implications," Statement Before the House Subcommittee on Financial Institutions and Consumer Credit, (May 11, 2005).

corrective action. Another concern is that the new Accord does not assess a capital charge for interest rate risk, and therefore does not accurately adjust for the true riskiness of the institution. Further, the ability of the bank regulators to effectively supervise and monitor the new system has also been called into question.

One very controversial issue relates to the competitive benefits that the Basel II Accord may provide to covered banks compared to the rest of the industry. For example, one economic analysis estimated that the capital charge for prime mortgage loans with an 80 percent loan-to-value ratio could be as low as 29 basis points for Basel II banks.⁹ If correct, this disparity in required capital would provide a significant competitive advantage for Basel II institutions, since a lower capital requirement for a product reduces the cost to offer that product. The result could be a gain of market share for products that receive a lower capital charge under the Basel II framework. Further, Basel II provides incentives for non-covered banks to concentrate on the riskier segments of the market within a product line (e.g. subprime loans), since the advantages of the Basel II system are diminished or even reversed as the riskiness of the credit increases. However, an increased concentration of riskier credits in smaller institutions would itself create risks for the banking system and deposit insurance funds.

Another concern is that Basel II may encourage further consolidation within the banking industry. To the extent that this new capital standard results in lower capital requirements for larger institutions, it makes these institutions more profitable for their shareholders and thus attracts additional capital that could be used to acquire less profitable banks. Moreover, the very act of acquiring a non-Basel II institution could free up additional capital for the acquiring bank. When a Basel II bank acquires a smaller institution, the newly acquired assets would become subject to the Basel II framework as a result of the acquisition, potentially freeing up capital that prior to the acquisition was needed to support the smaller bank's operations. One estimate predicts that as a result of Basel II, consolidation in the banking industry could double the existing rate of consolidation.¹⁰

The Leverage Ratio

In addition to the risk-based capital standards, the U.S. agencies currently apply a leverage ratio requirement to insured institutions. The leverage ratio is the non-risk adjusted ratio of tier 1 capital to total assets. The minimum leverage ratio is generally set at 4 percent (3 percent for certain highly rated banks).

It has been argued that even if the Basel II framework reduces a bank's capital, the

⁹ Calom and Follain, A Proposed Competitive Impacts of Basel II in the U.S. Market for Residential Mortgages, Statement Before the House Subcommittee on Financial Institutions and Consumer Credit (May 11, 2005).

¹⁰ Karen Shaw Petrou, A Basel II Regulation: U.S. Market and Competitiveness Implications, Statement Before the House Subcommittee on Financial Institutions and Consumer Credit (May 11, 2005).

institution would still have to comply with the leverage ratio, thus mitigating competitive and other concerns. However, the leverage ratio only takes into account on-balance sheet assets. A large bank could effectively reduce the impact of its leverage ratio requirement through financial transactions that move assets off the institution's balance sheet.

More fundamentally, the leverage ratio would appear to be inconsistent with the principles of the new standard, and arguably should be adjusted or eliminated for Basel II banks. The underlying rationale for Basel II is that it more accurately matches the capital of an institution to the risk presented by the institution's assets. It is hard to rationalize requiring institutions to comply with the Basel II requirements, at a considerable cost to the institution, for the purpose of determining a more risk sensitive capital requirement, but then prevent the institution from actually benefiting from the new system by retaining a leverage ratio that does not recognize the true risk of the institution's assets. This result would be harmful not only to the institution, but to the economy in general, since requiring a lending institution to hold excess capital will increase the cost of credit for the economy. It would also be harmful with respect to the global competitiveness of our international banks, since other Basel member countries will not be imposing a leverage constraint on their international financial institutions. In short, as a practical matter, it will be very difficult for the supervisory agencies to retain the leverage ratio in its current form for Basel II banks after the new Accord is implemented.

Current Status of Basel II Implementation

As previously mentioned, the Basel II framework was agreed to by the Central Banks and other bank supervisory authorities of the member countries on June 26, 2004. The Accord calls for the standardized approach to commence for non-U.S. institutions on January 1, 2007, and final implementation worldwide by January 1, 2008. Each member country is now proceeding to meet these deadlines pursuant to its own laws and customs.

In the United States, Basel II must be implemented through the issuance of new final regulations pursuant to the Administrative Procedure Act. As part of this process, the agencies issued an Advance Notice of Proposed Rulemaking on July 2003, as well as proposed supervisory guidance in October 2004 and in January, 2005. The original timetable called for the publication of a more formal notice of proposed rulemaking in the Summer of 2005.

On October 29, 2004, the U.S. banking agencies asked 26 large banking organizations to participate in a qualitative impact study or AQIS to determine the effects of the Accord. The results of this study, QIS-4, were released in the Spring of 2005. It indicates that the potential changes in capital that would be achieved under Basel II were significantly more substantial than previously estimated,¹¹ and that the bank's calculations of key factors, such as the probability of a default and the loss given a default, differed widely for the same category of

¹¹ Changes in effective minimum required capital for individual institutions ranged from a decrease of 47 percent to an increase in 56 percent.

assets. In particular, QIS-4 found substantial reductions in capital for all but one category of wholesale and retail lending, and a large capital reduction for mortgage and home equity lending.

As a result, on April 29, 2005, the banking agencies announced a postponement in publication of the notice of proposed rulemaking, during which time the QIS-4 results will be further analyzed and studied. Once this analysis is complete, the banking agencies plan on continuing the rulemaking process with the publication of a proposed rule. Additionally, the agencies have announced plans to modify the Basel I standards applicable to the remainder of the industry. According to the Federal Reserve, the revisions to the Basel I standards are intended, among other things, to blunt the unintended harm that Basel II might impose on non-adopters.¹² Finally, on July 13, 2005 the Basel Committee announced that it has discussed the schedules of national rulemaking processes within member countries and decided to review the calibration of the new framework in the Spring of 2006. In connection with this review, the Committee decided to undertake a new qualitative impact study (QIS-5) in October.

Conclusion

The current risk-based capital system needs improvement. It no longer effectively correlates capital and risk for many of our larger depository institutions. It creates perverse incentives for banks to sell or securitize their best assets and to retain riskier assets. It does not represent the state of the art in risk management or capital allocation. Basel II contains many improvements over the current capital framework system for our large and internationally active banks.

On the other hand, the proposed new framework may well cause unintended competitive effects with respect to non-Basel II institutions, and could also result in unexpected variations in capital requirements for similarly situated institutions. The task confronting our financial supervisory authorities is to extract the benefits of the new system while mitigating the potential for the unintended results.

While our very largest financial companies are capable of utilizing the advanced protocols of Basel II, there are many other depository institutions that could choose to use and benefit from the other models authorized by the international Accord, but rejected by the U.S. regulators. For example, implementation of the standardized approach (with modifications to reflect the unique nature of the U.S. financial system) would not only mitigate many of the potential anti-competitive effects of Basel II, but would also offer to all depository institutions in the U.S. the ability to be on the same level playing field as banks in Europe and Asia.

¹² Statement of Susan Bies, Member of the Board of Governors of the Federal Reserve System, before the House Subcommittee on Financial Institutions and Consumer Credit (May 11, 2005).

In this regard, we note that the agencies are expected to unveil a proposed new capital standard for non-Basel II institutions, perhaps as early as this Fall. In developing this so-called "Basel I-A" option, the regulatory agencies should carefully consider whether the proposed changes will be sufficient to meaningfully mitigate the anti-competitive effects of Basel II, and the extent to which the proposal will make capital requirements more risk sensitive for all institutions eligible to comply. At a minimum, the current four risk baskets could certainly be modified and expanded into additional baskets that more closely align with risk.

It is also important for the agencies to use the rulemaking process to reduce, to the maximum extent possible, the formulaic nature of the new Accord and to provide discretion for banking organizations and the supervisory authorities adjust capital based upon the principle that capital should reflect the true risk of the institution. Thus, for example, the regulations should provide incentives for banking organizations to use the best methods possible for determining the risk of assets, even if those calculations differ from the formulas set out in the Accord. Likewise, the banking agencies should be able to modify capital requirements, either up or down, based on their supervisory judgment and examination of the institution. It is also important to allow the new system to be phased in over a period of time. This will permit the institutions and the regulators to monitor how the new system is impacting capital requirements. Considering the stakes involved, a go slow approach may well be the best approach, it will permit adjustments to the standards before unintended adverse consequences are widespread.

Finally, the regulators need to squarely face up to the fact that the current leverage ratio cannot be maintained after Basel II is implemented. The leverage ratio needs to either be phased out or significantly modified for those banks subject to the Basel II framework, and the recognition of this fact should be made part of the overall process of implementing the new framework.

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September 13, 2005

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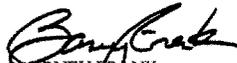
The Honorable Alan Greenspan
 Chairman
 Board of Governors of the Federal Reserve System
 20th and Constitution Streets, N.W.
 Washington, D.C. 20551

Dear Chairman Greenspan:

We were disturbed by the attached American Banker article suggesting that Federal Reserve Board staff are actively discouraging Federal Reserve Bank staff from expressing independent views on the Basel II Capital Accord.

This is a very important issue as you know and it is necessary for Congress to be fully informed. Clearly, it is inappropriate for there to be any effort to interfere with the information Congress receives. If this article is accurate, we ask that you please take the necessary steps to ensure that no Federal Reserve official interferes with Congress's access to information.

Yours truly,


 BARNEY FRANK
 Ranking Member


 MICHAEL G. OXLEY
 Chairman


 CAROLYN B. MALONEY
 Ranking Member
 Subcommittee on Domestic and
 International Monetary Policy,
 Trade, and Technology


 SPENCER BACHUS
 Chairman
 Subcommittee on Domestic and
 International Monetary Policy,
 Trade, and Technology

Enclosure

In Focus: Stress Shows At Fed with Basel II Drive Sputtering

American Banker << OLE Object: Picture (Metafile) >> Monday, August 29, 2005
By Damian Paletta

WASHINGTON - The Federal Reserve Board faces a series of daunting challenges to keep Basel II on track, including internal divisions, fights with fellow regulators, and possible congressional interference.

The central bank last week urged its 12 banks to fall in line and communicate a unified message on Basel II as it prepares for a major strategy meeting next month with the other banking and thrift agencies. It also has repeatedly disputed charges it is bullying its fellow supervisors into adopting the plan, and that once implemented it would result in steep drops in capital at banks.

The stakes are high for the Fed, which has taken the lead domestically to complete the capital accord and hopes to have it implemented by 2008. But the agency is facing increasing skepticism it can release the next stage of the plan in order to meet the deadline.

A sign of the mounting pressure came last week when the agency's director of supervision sent a memo to all 12 regional banks the same day a front-page American Banker article said the effort was stalling. Trying to ensure the Fed speaks with one voice on Basel II, Richard Spillenkothen said he would soon issue question-and-answer sheets that Fed officials should use when discussing the capital standard with outsiders.

"During this period of continued negotiation and development around capital reform, it is critical that Board staff and Reserve Bank staff have good communications and coordination of activities," Mr. Spillenkothen wrote.

Observers said the Fed wants to keep strife within the agency from showing.

"There is obviously a high level of concern within the Fed, particularly at the board, about where Basel II is going," said Bert Ely, a banking analyst in Alexandria, Va. "They don't want anybody talking out of school. They want to reinforce that 'We are going to speak with one voice and that voice is going to come from Washington.' "

There has already been some disagreement. In April three economists with the Federal Reserve Bank of St. Louis wrote in *Regional Economist*, a quarterly magazine the St. Louis Fed publishes, that community banks could face a mortgage pricing disparity because large Basel II banks with lower capital requirements could cut loan prices.

Basel II banks "may be able to offer more competitive lending rates" than other banks, St. Louis Fed President William Poole wrote in an introduction to the article. "Banks not operating under Basel II, then, may have to look for loan opportunities that are not affected as much by the new approach."

The article contradicted a much-anticipated report released in April by four Fed economists, who said Basel II banks would continue to set their mortgage prices by secondary-market requirements, not capital levels. An earlier version of that report, by former Fed economists Paul Calem and James Follain, was not published, but its conclusions also supported the view that Basel II would give large banks an advantage.

Mr. Spillenkothen's memo also asked the Reserve banks to tell the Fed what bankers are saying about Basel II, as well as "other supervisory efforts related to economic capital, risk measurement, or risk management."

"This clearly shows that there is a level of concern at the Reserve banks, but it doesn't mean that the Basel process is going to blow up," said Jaret Seiberg, a policy analyst for the Stanford Washington Research Group.

A Fed spokesman downplayed the memo, saying it "is not unusual for the board to coordinate with the Reserve banks on policy issues, particularly during important stages in their development - such as this one during the implementation of new capital regimes in the United States."

Some industry representatives said the Fed was trying to respond to a growing perception that the Basel II process has gone astray.

"There's a lot of questions going around about who should say what," said Pamela Martin, director of regulatory relations for the Risk Management Association. The Fed "needs to have a coordinated effort to get everybody on the same page. You want your examiners on the same page, especially when there are tons of rumors flying around. ... That's just good management."

The memo also underscored that some Fed officials are personally invested in the Basel II process.

"There is a pride of ownership at the Fed regarding the Basel committee," said David Fanger, the senior vice president of the banking group at Moody's Investors Service Inc.

A major impact study released in April handed critics - including other regulators - evidence that Basel II capital requirements might have flaws. The study, called QIS-4, showed an uneven spike and drop in capital requirements among banks, even at financial institutions with similar risk portfolios. Regulators had repeatedly promised capital levels would remain flat.

Federal Deposit Insurance Corp. Chairman Don Powell used the study as proof the process should slow down, despite the Fed's effort to issue a new proposal by yearend. He has said he does not expect regulators to have ironed out their differences in time. Some lawmakers have publicly said the Fed is rushing the other regulators - a charge the central bank denies.

Though Fed officials have maintained they could still make the deadline, Mr. Spillenkothen signaled in the memo that this was increasingly unlikely.

"We expect that this deliberative process, including the comment periods and requirements for OMB review, will extend well into next year," he wrote in the memo.

If U.S. banks are to implement Basel II by January 2008, all their systems would have to be in place by January 2007, because regulators want to run both the old standards and the new ones simultaneously for testing. That would give banks several months at the most to bring their systems into compliance once a final rule is issued.

Top federal regulators are expected to meet again next month ahead of an Oct. 3 Basel Committee on Banking Supervision summit in Switzerland to attempt to iron out their differences.

The Fed could also see Congress take a more active role. Senate Banking Committee Chairman Richard Shelby criticized the plan last month and said he wants to hold a hearing on the process in September or October.

"I'm not fully confident that the so-called 'right standards' have been proposed," Sen. Shelby said.

House Financial Services Committee Chairman Michael G. Oxley has threatened to pass a bill that would require the Treasury Department to step in if interagency conflicts on Basel II persist.



September 7, 2005

<p>Susan Schmidt Bies Governor Board of Governors of the Federal Reserve System 20th Street & Constitution Avenue, NW Washington, DC 20551</p>	<p>John M. Reich Director Office of Thrift Supervision 1700 G Street, NW Washington, DC 20552</p>
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<p>John C. Dugan Comptroller Office of the Comptroller of the Currency 250 E Street, SW Washington, DC 20219</p>	<p>Donald E. Powell Chairman Federal Deposit Insurance Corporation 550 17th Street, NW Washington, DC 20429</p>
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Dear Governor Bies, Director Reich, Comptroller Dugan and Chairman Powell:

Based on recent discussions between state and federal banking regulators as well as media reports and Congressional testimony on the findings in the fourth Quantitative Impact Study (QIS-4) for the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," commonly known as Basel II, the Conference of State Bank Supervisors (CSBS)¹ understands that the federal banking agencies plan to meet with our international banking regulatory counterparts in October 2005 and could indicate the U.S. intent on finalizing the Basel II framework. CSBS requests that the federal regulators *not* hastily commit to the international Basel II regulators regarding the U.S. implementation of the significant changes contained in the proposed Basel II rules.

When the Basel II discussions began nearly eight years ago, the intent was not to substantially reduce capital requirements for larger institutions from their current levels. Indeed, there has been no public consideration to date of the proposition that U.S. bank capital regulations are unduly conservative and need to be relaxed. The framework was envisioned to increase the capital required for riskier activities and reduce the capital required for the less risky activities. The initial discussions assumed that a Basel II proposal would basically be capital-neutral, or perhaps allow for a modest reduction in regulatory capital to induce banks to adopt the new approach. CSBS agrees with this initial concept.

¹ CSBS is the national organization of state officials responsible for chartering, regulating and supervising the nation's 6,240 state chartered commercial and savings banks and 400 state-licensed branches and agencies of foreign banks.

CONFERENCE OF STATE BANK SUPERVISORS

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September 7, 2005
CSBS Letter on Basel II

CSBS supports a more risk-sensitive capital framework for financial institutions. In this regard, we believe the general conceptual foundation of Basel II is appropriate. CSBS, however, understands that QIS-4 indicates that the average reductions in capital requirements based on the implementing rule for Basel II could be substantial. Capital requirements for specific business lines could change even more dramatically with QIS-4 outcomes, ranging from an increase of 50 percent to a decrease reaching 90 percent.

The QIS-4 results are of deep concern to state banking supervisors for several reasons. Although a limited number of institutions are expected to participate in the Basel II capital regime, we believe the capital reductions allowed under this proposal could place community and mid-tier, regional banks at a real competitive disadvantage. The current Basel II proposal seems to provide incentives that could hasten consolidation within the banking arena and threaten to further bifurcate the industry. In addition, minimal capital requirements at these large, complex financial institutions create systemic safety and soundness concerns.

Potential Implications

Implementing the risk-based capital requirements depicted in the recent studies could have profound competitive implications and significantly harm the banking industry in general and non-Basel II banks in particular. As proposed, Basel II creates significant differences between capital requirements of banks that adopt Basel II and those that do not. The current approach reduces the capital large institutions hold for mortgages and small business loans, among other assets. In a very practical sense, the reduced capital requirements would provide a pricing advantage for the larger institutions. It will be difficult for smaller banks to compete for mortgages and small business loans and certainly difficult for these institutions to hold such assets in their portfolio. In a competitive economy, eventually market forces will likely drive these assets from smaller banks toward the Basel II adopting banks, requiring non-adopting banks, the vast majority of which are small community banks, to move to higher-risk areas of banking.

In addition, with substantially lower capital requirements, larger institutions could acquire community and mid-tier banks without much cost involved by immediately lowering the acquired bank's required capital to a level that is allowed by Basel II banks. The lower capital requirements and the magic of the current Basel II mathematics promote the incentive for consolidation within the banking industry.

Under the current Basel II proposal, the quantitative amount of risk-based capital necessary to be considered well capitalized may be significantly reduced for diversified, large banks, thereby reducing the cushion when things go wrong. Mathematical formulas work in theory, but CSBS has reservations about how well these models can account for unexpected occurrences, such as a default by a large country, a sudden drop in housing prices, a dramatic change in the price of oil, or a meltdown of the derivatives market. The lower capital requirements could arguably also result in a substantial undermining of the prompt corrective action system enacted by Congress in 1991.

September 7, 2005
 CSBS Letter on Basel II

CSBS is concerned that allowing our country's very largest financial institutions to maintain capital at QIS-4 levels promotes the theory of "too big to fail," creates moral hazard issues, and poses a serious threat to the federal deposit insurance fund. We believe such an outcome would diminish bank management's accountability for risk management and allow an entity to take risks it would not otherwise. As we have seen on countless occasions in the past, these additional risks can be felt much more deeply at the local level than their overall effect on the national economy in general. Smaller communities can be devastated when their source of funds is restrained or completely disappears.

There may be ways of addressing the concerns described above by changing Basel II in a way that moderates its tendency to produce what we believe are unsafe and unsound capital levels. We ask that the federal agencies slow the Basel II process, take the time needed to find sound solutions, and not rush to implement a capital system that could produce undesirable impacts not only on capital and competition, but also on our citizens and the national economy as a whole.

Outstanding Issues

Prior to committing to our international regulatory counterparts on implementing Basel II in its current form, CSBS believes the following issues must be addressed and answered.

- What are the real life effects of Basel II? Prior to implementing final rules, the agencies should take into account not only the amount of capital institutions will be required to maintain but also the potential impact to the deposit insurance funds, the impact on product distribution between large and small banks, and the likely outcome for local communities.
- Should the leverage ratio be maintained for all institutions and, if so, what is the appropriate level? If the leverage ratio is maintained, will the cost of implementing Basel II be justified?
- How might small and community banks be affected by implementing Basel II? And, if they are put at a competitive disadvantage as CSBS believes, how do the agencies plan to change the current domestic capital rules, without increasing burden on those smaller institutions?
- Should the federal agencies extend the floor currently proposed for only the first two years? (The floor provides that a bank cannot reduce its capital by more than 80% under Basel II, even if the formula indicates a lower capital level.)
- Should regulators consider an alternative approach that is not based on complex mathematical formulas, but instead gives more discretion to the regulators to adjust capital based on the risk of the institution?

We strongly urge the federal banking agencies to obtain a much better sense of the real-life ramifications of executing Basel II prior to giving any indication to our foreign counterparts about implementation. Additionally, any potential changes to the capital requirements should be rolled out to *all* institutions simultaneously so as not to inadvertently provide pricing advantages to any particular set of institutions.

September 7, 2005
CSBS Letter on Basel II

Conclusion

The results from QIS-4 do not appear to adhere to the initial expectations of Basel II and cause great concern at the state level. CSBS is not convinced that Basel II as currently proposed is consistent with the responsibilities of banking regulatory agencies to prescribe by regulation an adequate level of capital. It also does not appear to be consistent with regulators' traditional function of promoting a level playing field.

Basel II makes a large bet with the future of the U.S. financial system. Accordingly, CSBS strongly urges the federal banking agencies to conduct further analysis of potential capital changes that would ensue from adopting the current Basel II proposal, reflect on agencies' initial expectations about potential capital changes, and take a measured and deliberate approach going forward.

Thank you for your consideration of these concerns. As always, CSBS and the state banking departments stand ready to provide any further supervisory information related to capital requirements as you desire.

Best personal regards,



Neil Milner, CAE
President and CEO

**Statement of
Independent Community Bankers of America
On
"The Current Status of Basel II"**

**before the
Subcommittee on Financial Institutions
and Consumer Credit
of the
Financial Services Committee
of the
United States House of Representatives**

September 28, 2005

**Independent Community Bankers of America
Washington, D.C.**

Statement to the House Subcommittee on Financial Services and Consumer Credit**"The Current Status of Basel II"**

The Independent Community Bankers of America appreciates the opportunity to present this statement regarding the current status of the Basel II Capital Accord as the U.S. regulators prepare for their meeting next week with the Basel Committee on Banking Supervision (Basel Committee).

Since Basel II will be the first significant revision of capital requirements since 1988 and will have a significant impact not only on the safety and soundness of the banking industry but also the overall U.S. economy, we fully understand and support the Committee's interest in this issue. Congress should maintain an oversight role in the Basel II process and should ensure that the U.S. regulators have a united position on Basel II when negotiating the new accord.

Summary of ICBA's Position

- ICBA remains concerned about the competitive disparities between Basel I and Basel II and recommends that the implementation of Basel II and the issuance of a Basel II Notice of Proposed Rulemaking (NPR) be delayed until the U.S. regulators have completed their analysis of the latest Quantitative Impact Study (QIS4) and have come to a consensus concerning its competitive impact.
- Prior to the issuance of an NPR on implementing Basel II, the U.S. regulators should also reach an agreement as to what specific changes need to be made to the new accord. U.S. regulators should not proceed with the implementation of Basel II knowing that revisions may have to be made in the future to make it more equitable or to ensure adequate capital at Basel II banks.
- Because the elimination of the existing capital-to-assets leverage ratio could jeopardize the safety and soundness of our financial system, ICBA strongly supports the retention of the leverage ratio once Basel II is adopted.
- The results of QIS4 indicate that the regulators should consider ways to simplify Basel II.
- ICBA fully supports the current effort by the regulators to revise Basel I to enhance its risk-sensitivity and to address any competitive equity concerns with a bifurcated framework. However, we believe there are few advantages in delaying revisions to Basel I while work on Basel II continues. We recommend that the regulators proceed with the issuance of an Advanced Notice of Proposed Rulemaking (ANPR) concerning a revised Basel I.
- ICBA recommends that the agencies institute a timetable for review of Basel I with a goal of implementing a revised Basel I concurrently with the

implementation date for Basel II, currently targeted for January 1, 2008. The ANPR concerning Basel I should be issued early enough so that the NPR for Basel I can be issued simultaneously with the NPR for Basel II. This would give the industry a chance to evaluate both NPRs at the same time and study and compare the competitive impact of each proposal.

Current Status of Basel II Implementation in the United States

In June 2003, the U.S. banking regulators issued an Advance Notice of Proposed Rulemaking to begin implementation for Basel II in the United States. The proposal formally set forth the U.S. regulators' position that Basel II would apply only to the ten to twelve largest U.S. banking organizations that have total assets of \$250 billion or more or total on-balance sheet foreign exposure of \$10 billion or more. Other institutions would have the opportunity to opt-in to Basel II provided they meet very strict eligibility standards. ICBA commented on the ANPR and expressed our concerns about the complexity of Basel II and the competitive inequities that would result if Basel II were implemented. ICBA also recommended further changes to Basel I to make that accord more risk-sensitive and address the competitive inequities presented by Basel II.

In June of 2004, the banking agencies described further their schedule for implementing Basel II in the United States. The agencies expected to issue a notice of proposed rulemaking (NPR) in mid-2005 and to release a final rule in mid-2006. In 2007, prior to implementation, the agencies expected to subject Basel II to a year of "parallel running," applying the framework in tandem with Basel I and in 2008, the new capital accord would be fully effective in the United States. The agencies also announced that they would be conducting a fourth Quantitative Impact Study (QIS4) to evaluate the potential effects of implementation and to help banking organizations understand the competitive implications of the new accord.

On April 29, 2005, the agencies issued a joint press release stating that they have completed a preliminary analysis of the QIS4 submissions and that the results indicated "material reductions" in the aggregate minimum required capital for the large banks that participated in the study. The agencies stated that they need more analysis to determine whether the results stem from differences in risk, data limitations, flaws in the study, or whether the results mean further adjustments to Basel II are needed. The agencies did say that they remain committed to moving forward with the implementation of Basel II while retaining Prompt Corrective Action and leverage requirements and that they plan to continue to work under the existing implementation timeline for Basel II which calls for full implementation of the new accord by January 1, 2008. They announced that the NPR would be delayed until further work was completed on the QIS4 results.

ICBA Remains Concerned about the Competitive Disparities Between the Basel I and Basel II.

ICBA has expressed concern for a number of years in previous testimony before this Committee and in our comments to regulators that Basel II may place community

banks at a competitive disadvantage. The Advanced Internal Ratings Based approach (A-IRB) of Basel II would 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 the third Quantitative Impact Study (QIS3) issued two years ago heightened our concern at that time about the competitive equities of the new accord. That study showed that the risk weights and capital charges would significantly decrease for retail credits including mortgage and non-mortgage loans to individuals and small businesses. A later study by the FDIC issued in December of 2003 showed that risk-based capital requirements would be so significantly reduced under Basel II that many banks would fall under the minimum 4% leverage ratio that is required for a bank to be adequately capitalized. Capital reductions for mortgages would be particularly significant, dropping an average of 56 percent on 1-4 family residential mortgages.

Preliminary analysis of QIS4 indicates that our concerns about the competitive inequities of the new accord are still justified. For residential mortgage credits, the preliminary results showed that minimum capital requirements for Basel II adopters would drop an average of 73% for residential mortgage loans and 79% for home equity loans. Currently, the minimum capital requirement under Basel I for these types of loans is 4% for well-capitalized banks. An average 73% or 79% drop would mean that minimum capital requirements for Basel II banks would be approximately 1% or less for these types of loans. For small business credits, the median percentage drop would be 27% and for other consumer credit (other than mortgage and credit card), 35%.

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 community banks by the 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 recent paper 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 banks 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 an important 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 customers.**

The Regulators Should Complete Their Analysis of QIS4 and Reach a Consensus About its Competitive Impact

In their joint press release of April 29, 2005, the regulators agreed that the implementation of Basel II in the U.S. and the issuance of an NPR needed to be delayed until additional analysis was completed on QIS4. The regulators said that additional work was necessary to: determine whether QIS4 results reflect differences in risk; reveal limitations of QIS4; identify variations in the stages of bank implementation efforts (particularly related to data availability); and/or suggest the need for adjustments to the Basel II Framework.

ICBA recommends that the implementation of Basel II and the issuance of any NPR be delayed until the U.S. regulators have completed their analysis of QIS4 and have come to a consensus about its competitive impact. So far, all that the

regulators have jointly issued about QIS4 has been a preliminary analysis that shows there is a wide disparity in minimum capitals between the two accords. A complete analysis needs to be done to determine the reasons for the disparity.

Furthermore, the regulators need to come to consensus about the competitive impact of Basel II. QIS4 appears to confirm the results of QIS3 about the competitive impact of Basel II. Yet there still appears to be differences between the regulators as to how serious the competitive impact will be to the Basel I banks and how to address the issue.

For instance, the FDIC indicated in its testimony before this committee on May 11, 2005 that the competitive impact was serious and could “significantly harm the community banking sector in the U.S., as well as large non-adopters.” To address this issue, the FDIC recommended further revisions to Basel II and Basel I and preserving minimum capital requirements for the Basel II banks.¹ However, the Federal Reserve, while acknowledging some concern about Basel II and its competitive effect, stated in its testimony before this committee that the competitive issue should be addressed by revisions to Basel I and that in any event, every effort should be made to adhere to the current implementation schedule for Basel II which calls implementation by January 1, 2008.²

Revisions to Basel II Should be Agreed Upon Prior to the Issuance of an NPR and Comment Periods on Basel I and Basel II Should Be Concurrent

Prior to the issuance of an NPR on Basel II, the regulators should reach an agreement as to what specific changes need to be made to the new accord and the NPR should reflect those proposed changes. U.S. regulators would be ill advised to proceed with the implementation of Basel II knowing that significant revisions may have to be made in the future. If the regulators were to delay making the revisions, it may be too costly at that point for the Basel II banks to make any significant changes, particularly after they have already devoted a considerable amount of resources building the necessary infrastructure to comply with the new accord. Once the QIS4 analysis is completed and the regulators have reached a consensus, the revisions need to be incorporated into the NPR so that banks would have the ability to evaluate the competitive impact of the revised accord and compare it with a revised Basel I.

ICBA recommends that the agencies institute a timetable for review of Basel I with a goal of implementing a revised Basel I concurrently with the implementation date for Basel II, currently targeted for January 1, 2008. The ANPR concerning Basel I should be issued early enough so that the NPR for Basel I can be issued simultaneously with the NPR for Basel II. This would give the industry a chance to evaluate both NPRs at the same time and study and compare the competitive impact of each proposal. A

¹ See the Statement of Thomas J. Curry, Director, FDIC of May 11, 2005 on “Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study.”

² See the Statement of Susan S. Bies, Member, Board of Governors of the Federal Reserve System dated May 11, 2005.

tandem Basel I and II schedule will also give the banking agencies the opportunity to make further adjustments to both accords if they are needed.

Because of the important role that community banks play as consumer and small business lenders, it is important that the regulators take their time to analyze the data from the QIS4 and make the adjustments to Basel II that are necessary so that when the new accord is implemented, there is no adverse impact to community banks.

The Leverage Ratio Should be Maintained Under Basel II

ICBA strongly supports maintenance of a capital-to-assets leverage ratio requirement for all banks. The QIS4 results illustrate that under the advanced approach of Basel II, there is potential for substantial deviations in the way banks compute their capital that are not always explainable by differences in risk. 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.

ICBA believes that eliminating or reducing the leverage ratio could jeopardize the safety and soundness of our financial system and pose substantial risks to the FDIC insurance funds. In recent years, U.S. banks have been very sound and profitable. ICBA believes that the current economic health of our economy and financial system is partly due to the strong capital position of banks and the capital requirements, including the leverage ratio and prompt correction action requirements implemented by regulators as a result of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

For instance, since 1989, the U.S. economy has experienced several economic downturns and recessions and banks have not only weathered these crises well but have served as pillars of strength for the economy. The healthy capital position of banks protected not only the banks themselves from financial problems but prevented these economic downturns from getting worse. In fact, Federal Reserve Vice Chairman Roger Ferguson stated recently that the capital levels that banks built up after the adoption of Basel I helped keep the 2001 U.S. recession relatively short and eliminated the threat of a vicious credit crunch or the risk of fragility in the system.

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 our economy would be enormous. As former 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."³

Basel II Should be Simplified

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. Our concerns were heightened earlier this year when the regulators admitted to making a simple mistake (a misplaced square root sign) in one of the complex formulas that was included in a recent guidance on Basel II. It took over two months for the regulators to spot the mistake. If institutions followed the formula as it appeared in the guidance, required capital requirements for retail loans could have been significantly understated by as much as 60-70%.

The wide diversity in the results from QIS4 also 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 preliminary results of QIS4, there seems to be little commonality in the approaches that various banks used to estimate their risk inputs.

ICBA recommends that the Agencies consider ways of simplifying Basel II to insure that banks will understand the formulas and apply them consistently. The new accord and its capital formulas must not be so complex that regulators cannot 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.

ICBA Fully Supports the Efforts by the Regulators to Revise Basel I

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. ICBA recommends additional risk categories for Basel I to enhance its risk-sensitivity and to align capital requirements with risk levels. The risk-weightings of these categories should also be modernized to better match current knowledge about actual risk exposures. For instance, lesser risk weights could be considered for rated credits and conforming mortgage loan products. Additional risk categories could be also added for loans with low loan-to-value ratios.

Hopefully, any proposed revisions to Basel I or a new Basel I-A will not make the capital accord overly complex. The advantage of Basel I to community banks is its relative simplicity. Community banks are burdened enough with existing banking regulation and they do not want the additional burden of having to comply with a very

³ Testimony before the Senate Banking Committee (April 20, 2004)

complex capital accord. Furthermore, regulators should also consider allowing well-capitalized, well-managed community banks the option to remain under the existing Basel I framework to reduce regulatory burden.

We believe there are few advantages in delaying revisions to Basel I while work on Basel II continues. We recommend that the regulators proceed with the issuance of an Advanced Notice of Proposed Rulemaking (ANPR) concerning a revised Basel I. This will give time for banks to fully evaluate the current accord and propose some revisions to Basel I.

As mentioned above, ICBA also recommends that the agencies institute a timetable for review of Basel I with a goal of implementing a revised Basel I concurrently with the implementation date for Basel II, currently targeted for January 1, 2008. This would give the industry a chance to evaluate both NPRs at the same time and study and compare the competitive impact of each proposal. A tandem Basel I and II schedule will also give the banking agencies the opportunity to make further adjustments to both accords if they are needed.

ICBA Supports H.R. 1226, the United State Financial Policy Committee for Fair Capital Standards.

ICBA supports H.R. 1226, the United States Financial Policy Committee for Fair Capital Standards Act, proposed by Chairman Bachus that would require a unified position among the regulators on Basel II. As note above, it is imperative that the regulators reach a consensus over all aspects of Basel II. This will not only give the U.S. a stronger negotiating position internationally before the Basel Committee, but will help ensure that any revisions to Basel II will be done correctly.

We support Congressional oversight of this process as contemplated by H.R. 1226. Congress should be kept apprised of the proposed revisions and should be consulted about their cost and complexity as well as their impact on competition between and among banks and other financial institutions. We also support giving the Director of the Office of Thrift Supervision equal representation with the other three bank regulators on the Basel Committee.

Conclusion

ICBA remains concerned about the competitive disparities between Basel I and Basel II and recommends that the implementation of Basel II and the issuance of any Notice of Proposed Rulemaking be delayed until the U.S. regulators have completed their analysis of the latest Quantitative Impact Study (QIS4) and have come to a consensus concerning its competitive impact. Prior to the issuance of an NPR on the implementation of Basel II, the regulators should also reach an agreement as to what specific changes need to be made to the new accord. The regulators should not proceed with the implementation of Basel II knowing that revisions may have to be made in the future to address the competitive issues. Because of the important role that community

banks play as consumer and small business lenders, it is important that the regulators take their time to analyze the data from the QIS4 and make the adjustments to Basel II that are necessary so that when the new accord is implemented, there is no adverse impact to community banks or their customers.

· Because the elimination of the existing leverage ratio could jeopardize the safety and soundness of our financial system, ICBA strongly supports the retention of the leverage ratio once Basel II is adopted. The results of QIS4 indicate that the regulators should also consider ways of simplifying Basel II since the banks do not seem to be taking a common approach to estimating their risk inputs.

ICBA fully supports the current effort by the regulators to revise Basel I to enhance its risk-sensitivity and to address any competitive equity concerns with a bifurcated framework. However, we believe there are few advantages in delaying revisions to Basel I while work on Basel II continues. We recommend that the regulators proceed with the issuance of an Advance Notice of Proposed Rulemaking (ANPR) concerning a revised Basel I. We also recommend that the regulators adjust their timetable to ensure that the Notices of Proposed Rulemaking for Basel I and Basel II are considered concurrently so that commenters can evaluate both NPRs at the same time and study and compare the competitive impact of each proposal.

Thank you for the opportunity to present our views on this important topic.