STATEMENT OF

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on

THE INTERAGENCY PROPOSAL REGARDING
THE BASEL CAPITAL ACCORD

before the

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

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

The Importance of Capital

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

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

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

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

Basel II

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Conclusion

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