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

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

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

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

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

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

Fortunately, a degree of sanity is now being restored to the Basel II process. U.S. regulators, unlike their foreign counterparts, wisely imposed on Basel I a floor on capital (known as the "leverage ratio"). They decided a year or so ago to apply that same ratio to Basel II. This limits the ability to rationalize large reductions in capital through modeling.

More recently, U.S. regulators amended the Basel II proposal to limit the percentage capital reduction that could occur in the Basel II banks, individually and as a group.

In July, four Basel II banks (JP Morgan/Chase, CitiGroup, Wachovia, and Washington Mutual) sent a letter to regulators requesting that U.S.

banks, like their foreign counterparts, be allowed to use the "standardized" approach to Basel II instead of being required to adopt the "advanced modeling" approach.

The standardized approach to Basel II is similar to Basel I in that it places various types of risks in buckets and assigns risk weightings to each bucket (Basel II has more buckets than Basel I). The standardized approach is vastly superior to the advanced modeling approach:

- **The standardized approach is much less expensive to implement and maintain. I have met with a number of the Basel II banks and understand that they have each spent between $100 million and $300 million in an attempt to build advanced models under Basel II. The banks I have spoken with believe their current systems for identifying, managing, and pricing risks are superior to the advanced approach.**
- **The standardized approach does not purport to deliver more reliability than can be delivered, while the advanced approach conveys a false sense of security and reliability. Among other things, large banks do not have detailed loss data going back as much as ten years, which means they do not have data for any**

period in which we have experienced serious economic and banking problems.

- **The standardized approach is less intrusive than the advanced approach and will allow the banks more flexibility to manage themselves. Models are important to large banks in managing and pricing risks. They are a management tool and are very poorly suited for use in setting regulatory capital standards. Banks need the ability to make continuous adjustments in their models and can't wait for a regulatory committee to decide what changes are appropriate.**
- **The standardized approach is more transparent and much easier for all of the important users of the information to understand, including boards of directors, senior managements, customers, investors, analysts, regulators, and the media.**
- **The standardized approach will produce a smaller disparity in capital requirements between large and small banks. Moreover, it will allow Basel II banks in the U.S. to be treated in the same fashion as Basel II banks in other countries, which are not required to use the advanced modeling approach.**

We have already experienced a great deal of consolidation in the U.S. banking industry, with the 25 largest banking companies now controlling some 70% of the nation's banking assets. I am convinced that creating a large disparity in capital standards between the large and small banks will lead to increased consolidation, leaving fewer banking choices for smaller businesses. Further consolidation in banking is inevitable, but it ought to be driven by market forces not by capital rules that favor larger banks.

It is argued that large banks from other countries will have a competitive advantage unless U.S. banks are allowed to use the advanced modeling approach free of limitations on reductions in their capital. I don't buy that argument.

The fact is that U.S. banks are by far the best capitalized and most profitable banks in the world. They do a great job of meeting the credit needs of businesses and individuals and are a major reason the U.S. has the strongest economy in the world.

***Other countries should emulate the U.S. system, not the other way around. The U.S. should urge other countries to impose minimum capital standards on their banks rather than enabling U.S. banks to lower their capital to unsafe levels*.**

Nearly every professional bank supervisor with whom I have spoken believes the advanced approach under Basel II is fundamentally flawed. Every major industry trade group has requested that the standardized approach be made available as an option. Congressional leaders on both sides of the aisle in the Senate and House clearly have grave reservations about the advanced approach under Basel II.

As noted, four of the Basel II banks have asked publicly that they be given the option of selecting the standardized approach. I believe many of the remaining Basel II banks feel the same way, although most are reluctant to speak out due to their concerns about regulatory reactions.

I said at the outset that an end to the Basel II ordeal is in sight. U.S. regulators should follow the path established by the Basel Committee and authorize U.S. banks to use the standardized approach.

The standardized approach will reduce the unnecessary complexity of Basel II and make it more understandable and transparent to all concerned. It will reduce greatly the cost of implementing and maintaining the system. Bank managements will retain the flexibility they need to change their internal systems for managing and pricing risks without first having to deal with a committee of regulators. Finally, it will reduce the disparity in capital requirements between large and small banks.

Now that the regulators have placed a number of safeguards around the advanced approach under Basel II, I am less concerned than I was about a precipitous decline in large bank capital in the U.S. Nonetheless, the advanced approach remains fundamentally flawed. Moreover, I worry greatly that a few years from now when different regulators are at the helm who will not have experienced the banking crisis of the 1980s, they will succumb to the pressure to eliminate or ease off on the safeguards.

I can't tell you how grateful I am that this committee has taken the time to focus on Basel II. This is by far the most important bank regulatory issue in front of us today. If we get this one wrong, our nation and taxpayers will almost certainly pay a very big price down the line – a price that will make the S&L debacle seem like child's play.

Let me close by emphasizing once again that no matter what anyone tells you to the contrary, it would be a serious mistake to allow our large banks, as a group, to reduce their capital materially. The largest banks in the world are a lot of things, but overcapitalized is not one of them.

Thank you. I will be pleased to respond to any questions you might have.