TESTIMONY

Next Steps for the Basel II Rules

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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.

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[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.