STATEMENT

of

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on behalf of

THE FINANCIAL SERVICES ROUNDTABLE

before the

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Chairman Bachus, and members of the Subcommittee on Financial Institutions and Consumer Credit, my name is Jim Garnett, and I am the Head of Risk Architecture for Citigroup. In that capacity, I am responsible for the implementation of the Basel II Capital Accord for Citigroup within the United States and other countries in which Citigroup operates.

I am here today on behalf of The Financial Services Roundtable ("The Roundtable"). The Roundtable is a national association of 100 of the largest integrated financial services firms in the United States. Roundtable members provide banking, insurance, securities, and investment products and services to consumers and business throughout the United States.

I would like to begin my testimony by emphasizing that The Roundtable strongly supports the implementation of the Basel II Capital Accord (the "Accord") in the United States. The existing Basel I regime has become outmoded for our larger institutions that routinely engage in sophisticated financial activities. Basel I does not accurately align regulatory capital with risk, and as a result has the perverse effect of rewarding banks that hold riskier portfolios, and penalizing banks that have more conservative banking practices. The U.S. needs to modernize its capital regulations, and there are a variety of new approaches that all represent a significant improvement over the current system, while the Basel I system could remain as an option for smaller community banks that maintain a traditional balance sheet. In a modern financial system, capital rules must be tied to economic risks. Inadequate regulatory capital requirements create safety and soundness concerns. On the other hand, excessive regulatory capital requirements constrain the lending and investment activities of the nation's banks and, thereby, reduce their ability to meet the credit needs of consumers and businesses.

The Accord establishes a three-part approach to capital regulation. Pillar1 provides for more risk-sensitive capital requirement for credit risk, market risk and operational risk. Pillar 2 requires that banks assess the need to provide additional capital, if any, for risks not covered by Pillar 1, such as credit concentration, and provides for supervisory review of a bank's capital adequacy and planning. Pillar 3 provides for market discipline through enhanced public disclosure. These three Pillars are intended to better align regulatory capital to underlying economic risks and to promote better risk management.

The Accord also is intended to promote consistency in international regulatory capital standards. While this goal is important for all banks, it is a particularly important aspect of the Accord for the members of the Roundtable that are active internationally. The harmonization internationally of a capital framework assures that all banks will be competitive when operating across national boundaries, and it avoids the significant compliance costs that would be associated with different capital regimes in different countries. It is important to emphasize, however, that competition and capital flows do not stop at national borders. Therefore, even those U.S. banks that have mostly domestic operations will be put at a disadvantage if foreign banks competing in the U.S. are subject to different capital standards.

Our concerns about the U.S. implementation of the Basel II framework, and the fact that the U.S. appears to be willing to significantly deviate from the international Accord, including the failure to provide U.S. institutions with a range of compliance options, led us to write to the four banking agencies on August 14 of this year. (A copy of the letter is attached to my testimony.) The proposed deviations from the international standards for the advanced approach, agreed to by all of the world's leading banking authorities, including our own regulators, will not only diminish the risk-sensitivity of this element of the Accord, but will also lead to unfavorable competitive disparities. I would like to elaborate on these concerns.

Diminished Risk Sensitivity

One of the key objectives of the Accord is to create an international capital framework that is more risk-sensitive than the Basel I regime. Creating a risk-sensitive capital regime is critically important for safety and soundness reasons:

- It aligns regulatory capital requirements with true economic risks.
- It recognizes the benefits of modern risk-mitigation techniques.
- It reduces the current incentives for institutions to shift their best assets off-balance sheet in order to achieve more favorable capital treatment.

Aligning capital with economic risk is also good for our economy. It ensures that adequate capital exists to cover risk, but does not result in excess capital requirements, which will have the economic effect of restraining the lending and investment capabilities of our financial institutions.

Unfortunately, the proposed U.S. version of the Accord includes a number of provisions that do not appear in the international Accord. These "add-on" provisions significantly diminish the risk sensitivity of the rule. For example, the proposed U.S. version includes a 10 percent limit on the amount aggregate minimum capital requirements may decline among Basel II banks. This is an arbitrary limit, which has no relationship to economic conditions. In strong economic cycles a drop in required regulatory capital of 10 percent or more may well be appropriate, and would not pose any safety and soundness concern. This provision also is unnecessary in light of Pillar 2, and the other supervisory tools currently available to the U.S. banking agencies to mandate an increase in minimum capital.

The U.S. regulators also plan on permanently retaining the existing minimum leverage ratio. This is a blunt regulatory instrument that requires an institution to hold a fixed percentage of capital against total assets, regardless of risk. We recognize that the leverage ratio has had strong support in the Congress. However, over the past decade banks and regulators have made significant advances in risk management techniques. These advances are reflected in the international Basel II Accord, and it is important to objectively review whether the leverage ratio is still necessary in light of the new framework, or whether the leverage ratio is in fact counterproductive to achieving a modern risk based capital system.

For many banks subject to Basel II, the leverage ratio will become binding. In other words, more capital will be required to comply with the leverage ratio than to comply with the risk based minimums. As a result, banks that invest in less risky assets will be penalized for such a strategy, since the leverage ratio will not change no matter how conservative the bank operates. Rather, some banks may be motivated to acquire riskier assets until their regulatory capital and economic capital requirements are equalized.

Moreover, to the extent the leverage ratio results in a higher minimum capital requirement than justified by the risk presented by the bank's activities, the regulatory requirement will have the effect of reducing the flow of credit to the economy. It will also make U.S. banks a more attractive target for acquisition by foreign institutions that are not subject to an equivalent leverage requirement.

While we do not support the permanent retention of the leverage ratio as referred to in the draft US proposal, we do not object to retaining a modified leverage ratio rule during the capital floor periods as an additional safeguard to mange the transition from Basel I to Basle II.

Competitive Marketplace

Another basic objective of the Basel Capital Accord is to foster international consistency in regulatory standards. Again, the proposed U.S. version of the Accord would frustrate this objective. Foreign banks are not subject to the various “add-on” provisions that are proposed for U.S. banks. They also have been permitted to implement the Accord more rapidly than U.S. banks. As a result, foreign banks will have a distinct capital advantage over U.S. banks in international markets. This not only helps them capture international business, but also gives them an advantage in mergers and acquisitions.

Similarly, the SEC adopted capital rules for certain U.S. investment banks that are consistent with the original Accord, and to date have not indicated any intent to modify these requirements. Thus, these institutions, which actively compete with commercial banks both domestically and internationally, will do so under a different, more advantageous capital regime.

The Costs of Compliance

The difference between the proposed U.S. version of the Accord and the version that is being implemented in foreign countries also creates a costly compliance issue for large banks. Large banks already have sophisticated internal risk models and risk management systems that are designed to establish the levels of economic capital required to support their activities. As the U.S. version of the Accord deviates from a truly risk sensitive system, the relationship between the existing business internal models and systems and regulatory requirements diminishes. As a result, banks will be forced to spend, literally, millions of dollars to develop and maintain two parallel systems for measuring risk: one that will be used for business purposes, and another that will be used only for regulatory reporting purposes.

What is the Rationale For the Proposed U.S. Version of the Accord?

What explains the proposed U.S. version of the Accord? The most obvious answer is the quantitative analysis (the "QIS IV"). Preliminary results of that survey seemed to show that the original Accord could result in a significant decline in capital for large banks. That analysis raised safety and soundness concerns among Members of Congress, competitive concerns among smaller U.S. banks, and caused federal regulators to question the validity of the inputs used by large banks in the survey.

In our opinion, the QIS IV quantitative analysis has assumed a greater significance than is appropriate. First, it used the existing Basel I capital level as a baseline. If one of the key goals of Basel II is to replace the non-risk sensitive Basel I regime with a more risk sensitive capital regime that aligns regulatory capital to true economic risk, the limitations of using Basel I as the baseline for measuring reform need to be understood. Second, the QIS IV measured only Pillar 1 risks. It did not evaluate the potential effect of capital for Pillar 2 risks. Finally, and most significantly, the QIS IV analysis was conducted at an extremely strong point in the U.S. credit cycle. What this means is that it examined the impact of the Accord on credit risk at a time when, using a risk sensitive measure, minimum regulatory capital requirements would be expected to be lower since the risks to the banks are lower when the economy is robust and credit is strong.

The Roundtable has data that indicates that if the analysis had been conducted during a weak part of the credit cycle (e.g., the recession of 2001) the average minimum capital for large U.S. banks under the Accord would have shown an *increase* in capital levels over the Basel I minimum. Additionally, it is important to distinguish minimum capital requirements from the amount of capital an institution actually holds, which normally is well above regulatory minimums. Thus, it is our view that the safety and soundness concerns that followed the release of the QIS IV analysis were, to a large degree, overstated. The Accord appropriately recognizes that minimum capital requirements should be reduced during good economic times, but then appropriately increased during difficult economic times.

Additionally, we would suggest that if a bank's capital plan called for excessive declines in capital, Pillar 2 of the Accord is the proper tool for addressing this. Pillar 2 is the supervisory review process that requires the regulators to assess a bank's capital planning processes.

With respect to the competitive concern of smaller banks, the federal banking agencies are addressing this concern through the development of the Basel IA proposal. Basel IA provides smaller banks with a more risk-sensitive capital structure, and may be an appropriate choice for many banks. The development of Basel IA is a constructive step in the implementation of the Accord in the United States, and we urge the federal banking agencies to publish the Basel IA NPR as quickly as possible.

Finally, we believe that concerns over the validity of existing internal models can be resolved by the rigorous validation requirements in the rule, as well as through the supervisory process. The large banks that use internal models have been doing so for years, and have demonstrated their reliability throughout all phases of the credit cycles. Further, the largest U.S. banks have fulltime, resident regulatory examination teams with detailed knowledge of and access to the bank's detailed capital management processes.

Our Recommendations

The answer to our concerns with the proposed U.S. version of the Accord is two-fold: (1) harmonize the U.S. version of the advanced approaches with the internationally negotiated text; and (ii) offer all U.S. banks the same options for compliance that are available internationally.

Harmonization of the advanced approaches would ensure that those institutions that choose to use the internal risk based models will have regulatory capital requirements that best reflects the risk of their assets. It will enhance competition on the international level. It will better align the actual business internal risk models and risk management systems with regulatory requirements.

Offering various compliance options is likewise critically important. Options for US banks should include the international Advanced approach and simpler approaches, which could include Basel 1A and the international Standardized approach. We would also suggest that for some small community based institutions, continued use of the existing Basel I standards may well be appropriate.

Giving banks a choice of methodologies for risk-based capital compliance has several benefits. It allows banks to choose among methodologies that are simple and transparent; it assures a competitive marketplace both domestically and internationally; it ensures appropriate minimum regulatory capital requirements; and it allows banks of all sizes to make their own cost/benefit assessments of the risk sensitivity of each option.

We acknowledge that the introduction of options at this point in the rulemaking process could result in some delay in the implementation of the Accord in the United States. We believe, however, that any delay should be minimal. A Basel IA notice of proposed rulemaking is expected to be released soon. The standardized approach (a summary of which is attached as an appendix) has been part of the basic Basel II framework. Its terms and conditions are set forth in great detail in the international Accord that the federal banking agencies approved in June 2004, and those terms and conditions are fully known and understood by the federal banking agencies.

On the whole, we do not believe material changes would be required and, therefore, the option can easily be incorporated into the U.S. version of the Accord.

Conclusion

The development and implementation of a risk-based framework for U.S. depository institutions that is consistent with the international community and creates a competitive marketplace is extremely important, both for purpose of safety and soundness, and to ensure that the capital resources of our nation's banks are optimized for the benefit of our economy. The Roundtable supports the development of a modern risk sensitive system, as developed by the world's leading developed countries represented on the Basel Committee on Banking Supervision. Regulators in Europe and elsewhere have implemented the agreement consistent with the original Accord. The current U.S. version of the Accord includes several provisions that have not been adopted by other countries, and does not give banks a choice of compliance methodologies, including the standardized approach. We urge the harmonization of the U.S. version of the Accord with the version that is being implemented in other countries, and giving all reasonable compliance options.

THE STANDARDIZED APPROACH

Risk-Weights for On-Balance Sheet Items

The current Basel I framework establishes a relatively unsophisticated risk-based capital standardized that places loans into broad categories, and does not evaluate counter-party risk. For example, all commercial loans are given the same risk weigh (100%) and all traditional mortgage loans are given the same weight (50%). The standardized approach significantly enhances the risk sensitivity of the capital requirement by recognizing that different counter-parties within the same loan category can present different risks. It also recognizes the value of various risk mitigation techniques. The following examples illustrate the enhanced alignment between risk capital under the standardized approach:

- Claims Against Corporations – Claims against corporations are assigned a risk weight according to the credit rating assigned to the corporation. Corporations with a credit rating of AAA to AA- are given a risk weigh or 20%, corporations with a credit rating of A+ to A- are given a risk weigh is 50%, corporations with a credit rating of BBB+ to BB- are given a risk weight of 100%, and corporations with a credit rating of less than BB- are given a risk weight of 150%. Unrated exposures receive a 100% risk weight.
- Retail Exposures (Loans to Individuals and Small Businesses) -- Loans to individuals and small businesses, including credit card loans, installment loans, student loans, and loans to small business entities are risk weighted at 75%, if the bank supervisor finds that the bank's retail portfolio is diverse. In comparison, retail and small business loans are placed in the 100% risk weight basket under Basel I.
- Residential Real Estate -- Prudently written residential mortgage loans are risk weighted at 35%. Although this capital charge is not adjusted for counter-party risk, the 35%

charge is closer to the actual risk of these loans than the 50% charge under Basel I.

- Commercial Real Estate Loans **--**In general, loans secured by commercial real estate are assigned to the 100 percent risk basket. However, the Accord permits regulators the discretion to assign mortgages on office and multi-purpose commercial properties, as well as multi-family residential properties, in the 50 percent basket subject to certain prudential limits. Under Basel I commercial real estate was assigned to the 100 percent basket.
- Claims Against Sovereign Governments and Central Banks **–** Unlike the current Basel I framework, which does not distinguish among OECD countries, the standardized approach assigns risk weights to Government debt based on the credit rating assigned by recognized Export Credit Agencies.

Off-Balance Sheet Items

Off-balance sheet items, such as loan commitments and guarantees, expose a financial institution to credit risk. Under Basel I no conversion (and thus no capital) is required for short-term exposures (one year or less). The standardized approach enhances risk sensitivity by converting short-term exposures using a 20% conversion factor. As in Basel I, longer term commitments are transferred using a conversion factor of 50%.

Credit Risk Mitigation

One of the most important differences between the standardized approach and Basel I is the acceptance of credit risk mitigation techniques. These techniques generally are not recognized under Basel I. The standardized approach enhances risk sensitivity by recognizing credit risk mitigation techniques, such as the following:

- *Collateral* **–** The standardized approach affords banks two options for recognizing collateral. Under the first option, a bank may use the risk weight attributed to the collateral if it is lower than the risk weight of the counter party. Under the second option, a discount is applied to the value of the collateral, based upon the credit rating of the counter-party behind the collateral, or the bank may calculate its own discount based on internal models.

- Netting **–** While Basel I recognizes certain bilateral netting agreements for derivative contacts, the standardized approach recognizes a variety of legally enforceable netting agreements.
- Guarantees and Credit Derivatives – The standardized approach also improves risk sensitivity by recognizing third-party guarantees and credit protection contracts that meet certain conditions.

Standardized Approach - Securitizations

The standardized approach permits a bank to exclude securitized assets from the calculation of risk weighted assets if the credit risk associated with the assets have been transferred to third parties, and the bank does not maintain effective or indirect control over the transferred exposures. The assets must be beyond the reach of the bank and its creditors. However, the transferring bank may continue to service the assets. Banks that retain or acquire positions in a securitization, or have an off-balance sheet exposure in a securitization, are required to hold capital with respect to these interests. The position is assigned a risk weight basket depending on the credit rating of the exposure. Originating banks must deduct from capital any “gain on sale” that results from the transfer of the asset into the securitization pool. If a bank sells revolving assets (e.g. credit card receivables) into a securitization structure that contains an early amortization feature, the bank will be required to hold capital against s specified percentage of the assets sold into the securitization (the investor’s interest in the pool). The percentage increases as the excess spread account (which serves to protect security holders) declines.

Operational Risk

The Basel II Accord has three methods for determining a capital charge for operational risk: (1) the basic indicator approach, (2) the standardized approach; and (3) the advanced measurement approach (AMA). Under the standardized approach, a bank can select any one of these methods for setting capital on operational risk.

- Basic Indicator Approach -- Under this approach the operational risk capital charge is set at 15 percent of the institution’s net positive annual gross income.
- Standardized Approach -- This method divides a bank’s activities in eight business lines (e.g. corporate, finance, retail, asset management, etc.). Gross income for each of the eight lines is then multiplied by a specified factor, ranging from 12 to 18 percent. The Accord also recognizes an alternative under which outstanding loans are substituted for gross income with respect to retail and commercial banks.
- Advanced Measurement Approach (AMA) -- Under the AMA, the operational risk capital charge will be determined by using the bank’s internal operational risk

measurement system. The Bank must track internal operational risk loss data and assess the relevance of that data to current operations. The data must capture all material activities and exposures in all systems and bank locations. External loss data must be used for events that are infrequent, yet potentially severe, such as an earthquake. Scenario analyses including expert opinion input must be utilized for high-severity events. The risk assessment should cover all key business environments and internal controls factors. Risk mitigation will be recognized. However, the recognition of third party insurance cannot exceed 20 percent of the total operational risk capital charge.