Testimony

Of

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This panel has led the way in recognizing the critical importance of the Basel risk-based capital rules, starting the policy debate in early 2002 with the first Congressional hearings on the rules long before many in the industry realized their critical importance. I was honored to testify then to offer views on the rules at that early stage and am grateful again now to outline ways to modernize the regulatory-capital requirements governing U.S. financial-services firms.

Sad to say, much of what I will say today is what I said in 2002 and at several later hearings on the proposal in the House and Senate. For example, in 2002, I urged the regulators carefully to consider the competitive implications of their rules. The House Financial Services Committee has pressed hard on this point and the agencies are now paying heed to it, but I fear that many aspects of the most recent proposal still do not address ongoing problems raised by the unique nature of the U.S. industry. It is different in many key respects from other national financial-services regimes, and U.S. rules must thus be carefully tailored to reflect U.S. reality.

There is, though, one key difference between 2002 and now: the Basel risk-based capital rules – for better or worse – are final everywhere else but here. Thus, we no longer have the luxury of pushing for a better international Accord. That is now final, and banks around the world will start to operate under it in January of 2007. This means not only that internationally-active U.S. banks will operate under anachronistic capital rules that place them at a disadvantage and that put the banking system at risk – that would be bad enough. However, it also means that foreign firms may have an undue capital advantage with which to enter the U.S. and acquire banks and other financial-services firms. As I said before this panel in May of 2005, M&A by global firms here is fine if it's a fair fight. It isn't fine, though, if our domestic institutions are gobbled up by foreign competitors able to engage in "regulatory arbitrage" solely because we can't make up our minds on our capital standards.

What are the key U.S. financial-system realities that must be kept carefully in mind as new capital rules are finalized? Put very simply, they are:

- We are facing emerging financial risks, most notably in housing and mortgage markets. We can debate all day long if the housing "bubble" will burst or fizzle, but we know for sure that U.S. consumers are highly leveraged and are making use in unparalleled fashion of high-risk mortgage products. The current Basel I rules applicable to all U.S. institutions woefully under-capitalize high-risk assets, creating a regulatory incentive for banks to hold them. Getting the risk right in risk-based capital is not just an issue for model builders. It's a critical challenge to protect the FDIC and the economy more generally.

- In the U.S. bank regulatory capital rules cover only insured depositories and a subset of parent holding companies. We have a wide range of charter options, the consolidated supervised entity (CSE) importantly among them, that permit astute companies to pick and choose among the charters. Outside the U.S., almost all firms fall under the Basel rules, eliminating much of the competitiveness concerns critical in the U.S. The Basel rules as now finalized may be good, bad or indifferent, but they will apply with few distinctions outside the U.S., ensuring the proverbial "level playing field." We will have a most uneven one – with dangerous systemic-risk ramifications – if the final U.S. bank capital rules do not reflect our charter and supervisory diversity. The proposed operational risk capital standard is particularly problematic in our competitive and legal reality.

- We have a unique capital requirement, the "leverage" standard proposed now to continue under the Basel IA and II regimes. Advocates of leverage argue that it will counteract possibly risky drops in regulatory capital. However, the leverage standard, while providing false comfort, exacerbates the charter disparities noted above because it applies only to some financial-services players, not to all of them. It is, further, no panacea for the problems in Basel. This panel will well remember the thousands of banks and S&Ls that failed in the 1980s and early 1990s even as the leverage standard applied to each and every one of them.

- We have thousands of banks, savings associations and credit unions – not just the four or five big players that dominate most other markets. Initial plans simply to ignore all but the biggest U.S. banks in the Basel rules have rightly been shelved, but the current proposal still has unnecessary restraints on what size institution may choose which capital regime. Each insured depository and, when applicable, holding company should choose the rules it thinks are right for it, not have that choice defined by its regulators. Supervisors have full powers – actually expanded under the Basel proposals – to intervene and add more capital if they think an institution's choice is risky.

With these thoughts in mind, I offer and urge the following recommendations related to the Basel rules in the U.S.:

- First, we need to get our rules in place as fast as possible. If we can't make up our minds on the more complex issues, leave them aside and finalize at least the simpler, "standardized" sections of the rules (revised for U.S. mortgage and other issues as necessary) and the Basel IA requirements. As noted, the current Basel I rules encourage risk-taking because there is no regulatory capital penalty for it. A simple rewrite that better equates risk-based capital to risk is urgently needed, and debate over the fine points of these highly-complex rules should not deter action on their key points on which there is, in fact, broad general agreement.

- Second, we should not cling to the leverage standard in hopes that it will protect us from "undue" capital drops. I very much doubt that risk-based capital under Basel II would drop here in anywhere near the amounts suggested by the fourth quantitative impact study, which was based on top-of-the-cycle numbers and back-of-the-envelope estimates. Putting banks and their holding companies through all of the hoops and all the added expense of the Basel rules and then slapping the leverage standard atop them undermines the entire point and purpose of the Basel standards and – importantly – is far from the guarantee of safety and soundness hoped by those now pushing for retaining the leverage standard. It should be discarded – especially for holding companies – and regulators should rely on their own powers and market discipline to press banks that might consider unwise capital reductions to think again.

- Third, the U.S. rules should not include an operational risk-based capital (ORBC) standard. The Basel IA proposal rightly does not include this and it should similarly be omitted from the Basel II rules. While this will put the U.S. Basel II rules at still more variance with the international Accord, it is necessary because of the lack of any agreed-upon methodology or measurement systems for operational risk. Worse still, a focus on ORBC will distract both banks and supervisors from urgently-needed disaster preparedness and contingency planning – capital is no substitute for back-up systems and advance planning as was made all too clear after September 11 and Hurricane Katrina.

- Finally, we must make up our mind and move forward. All of the benchmarks, caveats, limits and questions in the Basel II rules create wholesale uncertainty about what capital rules will apply when to whom. As noted, U.S. banks operate in the real world of aggressive competitors at home and abroad. We have proposed imposing not only new risk-based capital standards, but also new powers for regulators to buttress these – Pillar 2 – and new disclosure standards – Pillar 3 – to enhance market discipline. Far too little attention has been paid in the current debate to these critical elements of the overall Basel framework – indeed, they are almost unmentioned in the current notice of proposed rulemaking. Rightly structured, however, these two additional pillars will give U.S. regulators all the tools they need to ensure that capital is right for each bank under their purview without forcing institutions into the one-size-fits-all leverage standard, benchmarks, and other constraints on Basel now under consideration.

In conclusion, Basel critics might wish none of this had started and the U.S. could just get back to Basel I as is. This is understandable given all the flaws in the initial proposal and all the problems to which regulators turned a deaf ear for so long. However, it is critical to remember that Basel I as is rewards risk-taking and the leverage standard as is will do nothing to constrain this. It is also vital to remember that major competitors at home and abroad are now or will soon come under a more risk-sensitive capital regime with no leverage standard. Each and every one of these firms is a major force to be reckoned with in the U.S. whether or not it chooses to become a bank under the Federal Reserve's domain or headquarter itself here.

Thus, Basel II is here like it or not. Charters will be selected and deals done based on it, like it or not. The longer U.S. banks are kept under Basel wraps, the fewer of them there will be under our traditional regulatory framework. The longer Basel I is in place, the riskier our banking system will be – leverage standards now have no meaningful impact on risk other than to encourage taking it. Unless Congress is prepared to rewrite our rules and force all banks – big and small – and all competitors under the same capital regime – a major challenge that would keep Congresses busy for years to come – U.S. banks cannot be the last ones allowed to come under modern, risk-sensitive regulatory capital standards.