Statement of the

The Risk Management Association

Submitted to the

Subcommittee on Financial Institutions and Consumer Credit

Financial Services Committee

of the

U.S. House of Representatives

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The Risk Management Association is a member-driven professional association whose objective is to further the ability of our members to identify, assess and manage the impacts of credit risk, operational risk and market risk on their businesses and customers. While RMA was not invited to submit testimony to the Subcommittee for its September 14, 2006 hearing entitled, "A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate" RMA hereby submits this statement in support of a truly risk-based capital regime in which capital requirements are linked to risk. RMA has a tremendous depth of experience in the development of the revised Capital Accord. In 1999, RMA established the Capital Working Group[1] to provide industry input into the Basel Reform Process. As a result, RMA has been engaged in many direct discussions with regulators, submitted commentary on both Basel and U.S. proposals, performed surveys and analyses of U.S. bank practices, and otherwise devoted considerable time and energy to this work. Many of our members have likewise invested in the process of improving capital regulation.

RMA's membership includes some banks that would be required to operate under the U.S. version of the Basel rules; others that are working toward qualifying for this treatment as opt-in institutions; and still others that would operate under the general capital rules in the U.S. We have long supported the goals regulators set out when they began updating the Basel rules.

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[1] The RMA Capital Working Group consists of senior risk management officers at large banking organizations responsible for the measurement of risk and the determination of Economic Capital. Institutions represented include: ABNAMRO North American, Bank of America, Capital One, Citigroup, Comerica, Countrywide Financial Corp., HSBC/North American Holdings, JPMorganChase & Co., KeyCorp, M and T Bank, RBC Financial, State Street, SunTrust, Union Bank of California, U.S. Bancorp, Wachovia, Washington Mutual Bank, and Wells Fargo.

Today's capital rules are based in large part on the 1988 version of the Basel Accord. The reforms currently being proposed for the domestic industry are intended, at least in part, to align U.S. rules with the most recent Basel standards. This effort has been underway for a decade, and both U.S. and international regulators have engaged in a productive dialogue to tap into the best thinking on this subject by the industry and academia.

Bank regulations seek to simultaneously accomplish multiple objectives. Two of them are particularly relevant to a discussion of capital standards. First, regulations work to ensure the safety and soundness of the banking system and individual institutions. Second, they must enable banks to attract the capital needed for a healthy system by permitting banks to earn an adequate return on that capital.

Safety and soundness is largely a matter of being able to absorb the losses that occur in an uncertain world. The first line of protection against losses is ongoing profit; in nearly all cases individual loan losses simply mean smaller profits, not a net loss at the firm level. An adequately capitalized bank will have sufficient capital to absorb losses in those periods where actual losses occur. Safety can be enhanced in two equally effective ways – banks can take less risk and reduce the possibility of experiencing a loss, or they can hold more capital.

Holding more capital means that profits will be divided over a larger base, lowering the return on each dollar of capital. Requiring excessive capital levels makes it difficult for banks to earn an adequate return on that capital, with the risk that investors will move their capital to other industries or countries.

When the reform process began more than seven years ago, it was widely agreed that the 1988 Basel Capital Accord had taken only one step toward the objective of safety and soundness. At a minimum, it required that banks hold 8% capital for all corporate exposures (4% for mortgages), regardless of their relative risk. A high-risk bank needed no more capital than a bank with very low risk assets.

Absent rules requiring more capital for more risk, regulators wanted ample capital in *all* cases. Banks found it difficult to earn an appropriate return on the disproportionate capital required for low-risk exposures and consequently moved these exposures off their balance sheets or otherwise structured risks so that they did not require as much capital under these rules. These were not signs of a good rule.

Basel II was designed to align capital requirements with risk, ensuring that high-risk institutions were covered with adequate capital while enabling lenders to earn appropriate returns for low-risk business. U.S. regulators have clearly taken a leading role in the development of the new international framework and the formulas that set the minimum capital requirements.

Importantly, these new rules rely not only on the computed capital requirement, but also on two complementary elements, described as the second and third pillars of the Accord. Supervisory Review – long a key strength of the U.S. regulatory system – was introduced to provide assurance that banks are appropriately fulfilling their responsibilities under the new rules and to address risks that are not explicitly captured in Pillar I. The third pillar, enhanced disclosure, builds on a trend toward greater transparency.

The international Accord offers banks choices about the level of complexity they will adopt. For credit risk, the Standardized Approach is somewhat more risk sensitive than Basel I and requires only basic risk information. More complex information, including risk measurements developed from internal performance results, is required for the Foundation and Advanced Internal-Ratings Based Approaches. Developing these internal results so as to meet the demanding validation requirements of the Accord is very costly, but the rules are designed to build on the systems nearly all internationally-active banks have already built for their own risk management purposes. In fact, the *use test* is an important principle in the Accord, encouraging banks to improve their risk management quantifications and to use the results in the capital computations. Banks are spending hundreds of millions of dollars on systems that will be used for Basel, and duplicative spending on both internal systems and similar but different compliance systems would be an enormous and unnecessary cost burden.

The Basel Committee carefully calibrated the three approaches for credit risk in order to satisfy two criteria. First, the calibration enhances safety and soundness. The Standardized Approach generally requires higher capital levels than the Foundation IRB Approach, while the Advanced IRB Approach tends to require the least. This means that capital requirements are normally higher for those banks whose risks are not as well quantified, and lower in those cases where we best know the risk. But specific requirements put capital where it’s needed: advanced IRB banks that have high-risk portfolios require more capital than under the other approaches.

Second, the calibration encourages banks to invest in the expensive developments needed to qualify for the advanced approaches. While it is true that there are many business benefits for understanding risk better, most banks have already captured these in their internal systems. Still, there is clearly a large incremental cost to make internal systems suitable for Basel purposes. By allowing a better alignment of capital with risk, the international calibration permits advanced banks to put their capital to work more efficiently, justifying their large investments. Without this intentional calibration, banks would quite reasonably elect to avoid massive compliance costs and operate under the standardized approach, revealing less about their risk and the adequacy of their capital.

The U.S. and foreign regulators forming the Basel Committee adopted the Accord in June 2004, with an update following in late 2005 to address some residual issues. For banks using the Advanced approach, the Accord calls for a year of parallel operation in 2007. The new rules are to be used to set minimum capital levels beginning in 2008, although there are floors through the transition years of 2008 and 2009.

The Accord is not itself a rule. It is an agreement that must be put into effect through each country's legislative or rulemaking process. In much of the world – notably Europe and Canada – the Accord has been adopted largely along the lines agreed to in Basel. Banks in these areas will see their capital requirements aligned with their risks beginning in 2008, and some of our member banks report that they are already seeing an increased willingness of international lenders to price longer-term low-risk deals to reflect lower capital requirements.

Unfortunately, the U.S. situation is quite different. While other nations – and their banks, which compete with U.S. institutions – move ahead with this new, risk-sensitive regime, the U.S. process is mired in uncertainty and at risk of producing a rule that fails to deliver on the Basel objectives.

The U.S. regulatory implementation plans have for some time differed significantly from the framework agreed to in Basel. In 2003, the U.S. agencies announced through an ANPR that instead of offering several approaches with varying degrees of complexity, they would offer only the advanced approaches from the Accord, with large banks mandated to use the new rules and other banks permitted to opt in to them. Remaining banks would continue under the general capital rules. In late 2005, they proposed new general capital rules for non-Basel banks. The smallest banks would be allowed to remain on the old rules derived from the 1988 Basel Accord. The intent of these revisions was to make the general capital rules more risk sensitive, lessening the difference between the capital computed under the Basel rules and the general capital rules. The proposed new general capital rules, often called Basel 1A, used many of the risk sensitive concepts from the Basel Standardized Approach, but there were numerous differences and many open-ended questions that left the final form of the rule unclear. While the Basel Committee has conducted several quantitative impact studies to calibrate the approaches against each other, no such comparison has yet been done in the U.S., and RMA and its members are not able to estimate with much confidence how capital levels would compare among the alternatives, since there were so many unanswered questions in the 1A ANPR.

A year ago, U.S. regulators announced an additional delay around the Basel rules, and extended the implementation timeline with more conservative floors than provided in the Accord. Recently, the agencies adopted an NPR for Basel II that should be published in the Federal Register shortly. The NPR for the so-called Basel 1A has yet to be approved, calling into question the feasibility of hitting even the delayed implementation date and forcing banks to proceed with their efforts without promised guidance from the agencies.

More disturbing to banks that must adopt the rule, the NPR reveals a variety of disappointing changes that back away from the risk sensitivity agreed to in Basel, that create competitive problems for American banks, and that increase the compliance burden they face.

It appears evident that the U.S. banking regulators are reluctant to acknowledge that safety and soundness can be improved by low risk as well as by high capital. Documents released to date lead banks to conclude that U.S. rules will require more capital for the same risk than those adopted elsewhere. Further, a new test has been introduced in the NPR that points to an even more conservative *re*calibration if capital requirements fall appreciably. This trigger is stated without regard to economic conditions, even though a risk-sensitive framework in a cyclical economy will without doubt produce requirements that fall and rise with business conditions. Severely limiting the *potential* capital reduction in the best part of the cycle is equivalent to *raising* capital requirements, since banks will want to have on hand the capital needed for the next downturn. In fact, Pillar II requires banks to have sufficient capital to handle the cyclical downturns that occur from time to time, so that it is redundant to include it in the Pillar I computation.

U.S. banks also face a second capital requirement not found in Europe or most other Basel countries. Our leverage ratio requirement is not at all risk sensitive. As described above, it makes sense for capital requirements to be higher for banks whose risks are not as well understood. The leverage ratio does not *seek* to understand risk, and naturally requires lots of capital to ensure sufficient coverage without knowing how much risk a bank faces. It is not surprising, therefore, that the leverage ratio requirement is higher than the risk-based requirement for most institutions. While the Accord recognizes that greater safety can be achieved both by taking less risk and by reducing risk, U.S. rules look only to the latter. A bank must hold capital appropriate for higher risk even if it chooses to take less risk. This requirement for disproportionate capital levels has several negative consequences, which will be discussed in a moment.

First, however, we offer several comments about the 2004 Quantitative Impact Study, the results of which caused considerable concern among U.S. regulators and apparently led to the change in direction that the industry finds troubling. It is important to realize that the QIS provided a far-from-perfect preview of capital requirements under the Basel rules. Although one could see that lower risk portfolios tended to get lower capital levels, some results were inconsistent from bank to bank, which was not surprising, given that banks were only partially through their implementation efforts and regulatory guidance was incomplete, at best. It seems clear that some low numbers will increase to look more like those submitted by other banks, with the result that the overall change in capital is a smaller decrease than shown in the study.

Further, the QIS was performed at the very best part of the credit cycle. Several of our member banks have shared with regulators their analyses showing that capital requirements will be significantly higher in a period such as the 2000-2001 recession than reported in the QIS. Actual capital levels are unlikely to decline as much as minimum requirements in very favorable years, both because the Accord requires banks to have on hand the capital needed for anticipated future downturns and because banks will not want to raise new capital in a recession.

The QIS results from some institutions may also be misleading because the risks *not* covered by the Pillar I formulas are not necessarily proportional to those that are covered. For example, mortgages tend to generate very low credit risk capital charges because of their low loss rates, but holding mortgages often entails interest rate and other risks that are larger – in proportion to credit risk – than for other loans. The capital rules have mechanisms under Pillar II to ensure that any institution with a significantly above-average proportion of their risks in an area like this would hold appropriate capital to cover such risks; their capital will not be permitted to decline as much as might be indicated by their QIS results. Some members report that their supervisors have already begun discussions toward resolving these issues. For most institutions, however, these risks will be covered by the calibration of the credit risk capital charge.

Among the most serious consequences of the U.S. mandate for high capital levels is that it puts U.S. banks in a difficult competitive position. Investors seek a higher return on capital than is required for funding from liabilities. Assets funded with more capital must be priced higher than those funded with less capital to earn an acceptable return. Banks operating under risk-sensitive capital requirements can better compete for low-risk loans than institutions that must hold extra capital. The disparity is greatest for assets that have the least risk. U.S. banks will have to forgo such business, or counterbalance low-risk business by taking on more high-risk loans to keep risk-based capital requirements about as high as the non-risk-based requirements. A regime that associates safety and soundness exclusively with high capital rather than low risk will push banks away from low-risk strategies, since that approach will require disproportionate amounts of capital, lowering the return earned on each dollar of capital. It is inappropriate that regulations would discourage U.S. banks from adopting a low-risk approach to their business.

The NPR's conservatism plays out in another damaging way. The new Accord was presented as building on the systems banks have already put in place. The very name "Advanced Internal-Ratings Based Approach" signals that it is to use the *banks'* systems. A prime benefit of this approach is that the regulatory systems will improve as banks get smarter. Basel requires that banks capture lots of information and analyze it, which will clearly lead to an improved understanding of risk.

Unfortunately, the NPR contains so many conservative, prescriptive requirements for the methodologies used to generate the inputs to the capital formulas that banks will commonly be unable to use their own processes. Redundant systems, with no use save compliance, must be built at great cost. The Basel rules establish rigorous validation requirements, but U.S. regulators appear unwilling to trust these processes, even though they will oversee them. Instead, it appears that when in doubt, regulators have frequently written very conservative assumptions into the rules. With this approach, the U.S. regulatory system will be stuck in time using today's practices – or in some cases practices that even today are no longer standard – as opposed to best practices. The gap between bank internal risk measurement systems and the Basel II compliance system will grow as time passes. Banks will have to keep up with new developments, but it is unclear that a narrowly defined regulatory system can remain current.

The excuse for imposing detailed methodologies where banks already have internal processes is that uniform approaches are needed in order to make comparisons from bank to bank.   RMA is concerned that regulators expect all banks to have the same view of each risk, even though it is altogether reasonable that banks should often have *different* assessments of risk – this is why some banks make certain loans and other banks make other loans.

RMA expects that bank-to-bank comparisons will improve as the industry gains additional experience benchmarking their internal data as part of the validation requirements. The industry and RMA are already working toward this objective, even before regulators take the next steps. Our Capital Working Group is preparing right now to update a benchmarking survey for retail loans. We have found it quite possible to make such comparisons without mandating that everyone use a single methodology, underscoring the need for the capital rules to be principles-based rather than prescriptive.

Even as prescriptive rules have increased compliance costs, the burden has been exacerbated by the uncertainty and delay in the rulemaking. In many key areas the agencies have yet to provide guidance, and in others the draft rules indicate that guidance will change. Nevertheless, the documents are hung up in the morass of the interagency rulemaking process. Meanwhile, U.S. banks are expected to proceed with multi-million dollar implementation efforts. How much of this work, they wonder, will have to be thrown away when the real rules are finally disclosed?

To conclude, the RMA and our members support the objectives behind the Basel rules, and we strongly desire a risk-based capital framework for the U.S. We continue to support adoption of an advanced approach that is equivalent to what is being implemented in the rest of the world, and we believe it should offer advantages such that banks elect to use it rather than being forced to use it. We support revising the rules for non-Basel banks to be more risk sensitive, too, with options that are matched to the size and complexity of these institutions. All of these approaches must be designed such that the burden of implementation is reasonable and appropriate. They must also be calibrated to work together to provide a safe and sound banking system while enabling banks to attract the capital needed for a healthy system by permitting them to earn an adequate return on that capital. Finally, and most importantly, the new capital standards must be set to evolve over time as additional advances in risk management practices within the industry take place.