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U.S. Senate Banking, Housing and Urban Affairs Committee

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Mr. Chairman, Senator Sarbanes, I appreciate your invitation to testify today. I am currently Professor of Law at Georgetown University Law Center and a non-resident Senior Fellow at the Center for American Progress. I teach, among other things, Banking Regulation and International Economic Law. At present I am completing work on a book about Basel II. As you know, I held several economic policy positions in the Clinton Administration, ultimately as Assistant to the President for International Economic Policy. I testify today purely in my individual capacity as an academic, with no client interests or representation.

Last November many of us sat in this same room considering essentially the same issues we are discussing today. We questioned the reliability of the Advanced Internal Ratings (A- IRB) approach as a method for setting regulatory capital levels. We stated concern at the prospect of significantly reduced capital levels under that approach. We expressed skepticism that banks adopting the approach could be adequately monitored by supervisors, and that adequate oversight of the supervisors of A- IRB banks was feasible given how opaque the whole process would be.

Today it is appropriate to assess where progress has been made in the last ten months and, just as importantly, where it has not been made. As has been true throughout the Basel II process, the details of this saga can be arcane. But we should make no mistake about what is at stake here - the basic soundness of our banking system in an era of massive capital flows, highly complex banking institutions, and constant financial innovation.

The bottom line is that the big questions about the advisability of the A-IRB approach in Basel II have not been answered satisfactorily:

--The banking agencies have yet to demonstrate they can predict what the impact of the A-IRB approach will be on bank capital and on competition among U.S. banks adhering to different capital methodologies.

--Distinguished academic economists - of all political persuasions, I might note - continue to question the very foundations of the A-IRB approach.

--The implementation of the A-IRB approach in individual banks will necessarily be highly opaque to anyone outside the bank, with the possible exception of a team of unusually expert regulators dedicated to that bank alone.

--The whole approach is a monitoring nightmare - from the difficulty in monitoring how the banks are implementing A-IRB, to the near impossibility of public and Congressional monitoring of how well the regulators are doing their job under A-IRB, to the enormous challenge for U.S. regulators in determining how successfully their foreign counterparts are in administering this enormously complex approach to capital regulation.

--There is no plausible plan for reaching international agreement on the nearly continuous revisions of A-IRB that will be necessary if it is to satisfy its stated aim of utilizing state-of-the-art risk assessment techniques in calculating minimum regulatory capital.

Thus, just as was the case last November, it would not be prudent regulatory policy to rely on this approach to set regulatory capital requirements. Indeed, it has become increasingly clear that the A-IRB approach is fundamentally flawed.

However, despite my misgivings about the path on which Basel II could put bank regulation in the United States, I do not think we can or should delay action indefinitely. The challenge is how to move forward without endangering regulatory capital levels, imposing large unproductive compliance costs on banks, or ignoring the international arrangement into which the banking agencies have entered. Fortunately, there have been two significant positive developments address this challenge. First, the four federal banking regulators have, in their Notice of Proposed Rulemaking (NPR) for implementing Basel II in the United States, recognized the potential risk posed to capital levels by the A-IRB approach. This recognition is evidenced by their inclusion of a series of floors limiting how much minimum capital levels can fall for banks adopting this approach.

Second, four of the largest U.S. banks have recently suggested a sensible way to move forward in implementing Basel II. They propose permitting U.S. banks to choose among all three Basel II methodologies, rather than requiring our largest banks to adopt the A-IRB approach, as has been the stated intention of the banking agencies to date. Coupled with the floors on capital reductions under A-IRB, making this option available would protect capital levels while allowing banks that so choose to avoid assuming substantial compliance costs for a methodology that may ultimately prove unworkable.

In the balance of my testimony I will first review the key aspects of the current, somewhat dispiriting situation. Next I will elaborate on the steps I believe the federal banking agencies should take to move forward, including accepting the proposal of the four banks. Finally, I will suggest how, with this provisional solution in place, our regulators and industry might proceed towards a satisfactory longer-term regulatory capital regime.

The Current Situation

This hearing is certainly not the place to recount the long and tangled history of Basel II. However, certain elements of that history shed light on the circumstances in which we find ourselves today. First, it is important to note that, as a group, large banks were not proponents of the A-IRB approach to capital regulation. At the outset of the Basel II process, in 1998, many large banks had urged the Basel Committee to allow them to use their internal credit risk models as the basis for determining minimum capital levels. The Committee quite properly rejected that approach, citing problems with data reliability and model validation. Instead, it began what turned out to be a long, painful process to develop what is, in effect, a new credit risk model - but one created from scratch by the banking supervisors, to be imposed on banks.

The Committee appeared to regard the internal-ratings based approach as a compromise that would utilize the internal credit ratings systems of banks to calibrate exposure risks more precisely than the rather blunt Basel I categories, while keeping under the control of the Committee the formulas by which capital requirements would be generated from the banks' risk ratings. While banks did not reject this approach outright, many criticized - often severely - the specifics of each Committee proposal. There was definitely merit in some, though by no means all, of these complaints. For three years, the Committee was largely on the defensive, responding to criticisms by making numerous modifications - some of them major - in its proposal.

Second, the attitude of large banks towards the A-IRB approach seems to have changed only as it became likely that the nearly continuous revisions to this proposal in response to industry complaints would result in sizeable reductions in minimum capital requirements. Although the banks certainly never stated their position as such, I inferred their view to be that the A-IRB approach might not be a very good way to assess risk, but they were willing to adopt this methodology if it would reduce their capital requirements substantially. This, of course, is exactly what the later Quantitative Impact Studies suggested would happen.

This observation about the banks' position should be neither surprising nor read as a criticism of the banks themselves. It is understandable that banks would seek to minimize their regulatory obligations in pursuit of higher profits. The problem, of course, is that banks are not like most companies. Because of deposit insurance and market perceptions that the Federal Reserve will rescue large banks that encounter serious financial difficulties, American taxpayers actually bear some of the risk that banks themselves assume. That is one of the principal reasons why we have capital regulation in the first place, and that is why the protection of regulatory capital minimums is so important. Third, as already mentioned, the four federal banking agencies have responded to the prospect of significant declines in minimum capital under A-IRB by proposing stronger safeguards in their recently approved NPR. At this Committee's November 2005 hearing, the regulators reiterated their previously announced intention to limit the amount by which the regulatory capital of any A-IRB bank could decline during its first three years under the new methodology. They further offered the rather vague signal that, at the end of the three-year transition period, the primary federal regulator would decide whether or not the final (lowest) transitional floor should be retained.

In their recent NPR, the federal banking agencies have proposed three safeguards: (1) As they suggested last year, the agencies propose a transition floor for each bank in its first three years under A-IRB of 95%, 90%, and then 85% of the amount of capital that would be required under "general" capital rules. (2) The agencies also commit to modify the A-IRB framework if the aggregate capital of banks covered by this framework decline by more than 10%. This is considerably firmer safeguard than their previously stated intentions. (3) Finally, the agencies have strongly stated their intention to retain the leverage ratio requirement and other prudential safeguards as "critical for the preservation of a safe and sound regulatory framework."

In proposing these safeguards, the agencies have referred explicitly to the uncertainty surrounding the impact that the A- IRB approach will have on minimum capital requirements. Significantly, the agencies also invoked in the NPR the original stated aim of the Basel Committee to maintain the overall level of risk-based capital requirements. Fourth, the attitude of most large banks (that is to say, those which would presumptively be required to adopt the A-IRB approach) has again shifted since a draft of the NPR began circulating last spring. The capital safeguards proposed by the banking agencies will, by definition, limit the extent to which the regulatory capital requirements of large banks can decline. Now the banks face a dilemma. Their expectations for large declines in regulatory capital requirements have been dashed. But, under the terms of the NPR as circulated last spring, they will still be required to adopt A- IRB. This methodology will require them to expend substantial resources in creating and maintaining the elaborate systems required to implement this approach.

A-IRB is a credit risk model created by the supervisors. It is not tailored to a bank's particular mix of business, to its own portfolio, or to its own propensity to regularly enhance its internal credit risk model with state-of-the-art innovations. Thus our largest and most sophisticated banks will continue to use their own credit risk models. They will operate parallel credit risk modeling systems - one for business purposes, and the other for regulatory purposes. Accordingly, the banks will have to expend substantial additional resources on the A-IRB system, but without getting the benefits of large capital reductions they had anticipated.

Confronted with this situation, a number of large banks have had a dual response. First, in prior testimony and in other venues, they have urged removal of the safeguards for A-IRB imposed by the banking agencies in the NPR. Second, in a letter to the banking agencies, four banks have requested the banking agencies to reverse their decision of several years ago that only the A- IRB portion of Basel II will be available to U.S. banks (and required for the largest banks). Instead, they suggest that all three of the Basel II methodologies - which, most importantly, include the standardized approach - be available for adoption by any bank. The banks' request to remove the A-IRB capital safeguards should be strongly resisted, but their proposal to make all the Basel II methodologies available to any bank has great merit and should be implemented.

Sensible Steps for Moving Forward

Building on the banks' proposal to allow a choice between the standardized and IRB approaches, here are four steps I would recommend to break the logjam that has developed from the combination of concerns about capital levels, cost, and competition. The banking agencies should:

1. Permit internationally active U.S. banks to select between the A-IRB and standardized approaches of Basel II;[3]

2. Retain the NPR capital safeguards for any banks that elect the A-IRB approach;

3. Use their supervisory powers to require banks to adopt and maintain internal risk assessment and management techniques appropriate to their size and activities; and

4. Explore and pursue more viable approaches to capital regulation, both at home and within the Basel arrangements. Allow the Standardized Approach: This proposal of the four large banks has been gathering support since they put it forward during the summer. Groups with rather different perspectives, including the American Bankers Association and the Conference of State Banking Supervisors, have now endorsed their proposal.

Permitting large U.S. banks to adopt the standardized approach resolves the clash of interests and goals discussed earlier. All indications I have seen are that the standardized approach would not produce major declines in capital levels, either within individual banks or in the aggregate. At the same time, bank compliance costs would not be anywhere near the order of magnitude of costs associated with the A-IRB methodology. Thus capital levels can be protected while not forcing banks to expend large sums that neither assist them in their business assessments of risk nor yield them big capital reductions.

Adoption by large banks of the standardized approach would have other virtues. It is worth noting that the standardized approach does reflect some improvements from the Basel I rules, notably in the expansion in the number of risk-weighting categories and the use of external credit ratings to differentiate among the creditworthiness of debtors of the same type (i.e., corporations or sovereigns). It would also allay the concerns of non-A-IRB banks that the differential capital rules would give the A-IRB banks a systematic advantage in the amount of capital set-asides required for certain classes of loans. Finally, it will allow the United States to implement, without further delay, the Basel II Revised Framework, albeit in a somewhat different way than most had anticipated.

Retain the NPR Capital Safeguards: It is of course true that, if the standardized approach becomes an option, retention of the NPR capital safeguards will make bank adoption of the A-IRB methodology less likely. Frankly, that is probably a desirable outcome for a host of reasons. In any case, the safeguards should remain. No one, certainly no one in the banking agencies, has provided a rationale for why the capital requirements of our largest banks should be significantly reduced.

It is no answer to say that the A-IRB formulas indicate that capital levels could be lower. The Basel Committee regulators, after all, made up the formulas. While credit risk modeling can be helpful in calculating the relative risk associated with particular bank exposures, it cannot answer the ultimate question of how high minimum capital levels should be. This determination is not a mathematical computation. It necessarily involves a judgment on the optimal trade-off between the benefits of making more bank resources available for investment in productive activities and the costs that will be borne by taxpayers and the economy if banks fail or are rescued through injection of public resources. Another response to the banking agencies' proposal for capital safeguards under A-IRB has been that the competitiveness of U.S. banks will be adversely affected if large banks from other countries are able to operate under the A-IRB rules without these safeguards. The concern appears to be that the required (and actual) capital levels of foreign banks will decline dramatically, and the resulting lower effective cost of capital will allow those banks to extend credit in international markets at lower interest rates than U.S. banks could profitably offer.

I certainly do not dismiss competitiveness concerns out of hand. As with so much else surrounding Basel II, we cannot say with assurance what will happen. Indeed, the entire Basel exercise has come to look disconcertingly like a leap into the unknown. However, I would make two observations on the competitiveness point. First, despite the pervasiveness of competitive equality concerns in international capital negotiations, the nature of the relationship between capital requirements and competitiveness is complicated. Today our banks are among both the best capitalized and the most profitable in the world. Higher capital levels signal strength to counterparties, which may then be willing to extend funds at lower risk premiums. Moreover, although academic studies on competitiveness and capital requirements are far from definitive, some work that has been done suggests that national differences in tax, accounting, and other regulatory measures outweigh any leveling achieved by harmonized minimum capital standards.

Second, we do not yet know how Basel II will be administered in other Basel Committee countries - yet another of the significant unanswered questions surrounding the whole process. But if some competitiveness problem does arise because of lax implementation of A-IRB abroad, the solution is not to engage in a matching reduction of regulatory capital. The end result of a fragile international banking system in which everyone is similarly undercapitalized is hardly desirable. We should not become captive to the flaws of the A-IRB approach. The solution instead is to return to the Basel Committee with proposals for fair, effective, and cost-efficient capital requirements that will apply to all internationally active banks. I shall have more to say on this subject in a moment.

Exercise Supervisory Powers to Assure Appropriate Capital Levels and Risk Management. Minimum capital requirements are not, and should not be, the only means by which regulators assure that bank capital levels are appropriately high. Nor are they, or ought they to be, the principal means of risk management. Often lost in the discussion of the minimum capital levels of Basel II are Pillars 2 and 3 of the Revised Framework, which deal with supervision and market discipline, respectively. The United States already has perhaps the strongest tradition in the world of bank supervision -- by which I mean a non-rules-based interaction by supervisors with banks to understand their risks and direct them to take appropriate prophylactic or remedial measures.

Some U.S. banking officials have rightly expressed concern that large, complex banking organizations have systems in place that will allow them to recognize and provide for the risks they actually face, as well as to provide supervisors with an accurate picture of the bank's risk profile. They are correct that no relatively simple set of minimum capital rules will account for all such risks. But, of course, neither will the flawed A-IRB approach. Indeed, that approach would require large compliance expenditures that could better be spent on risk-management systems tailored to the circumstances of each bank.

If large U.S. banks choose to adopt the standardized approach to minimum capital requirements under Basel II, there is nothing to prevent their primary federal regulators from requiring those banks to establish and maintain sophisticated internal credit risk modeling systems. To the contrary, I would encourage them to do just that. This initiative would be a natural extension of existing U.S. supervisory practice and the principles enunciated in Pillar 2, but in a way that converges more closely with expenditures and practices that banks will undertake for business reasons in any case. It would also build on the progress that both banks and supervisors say has been made in credit risk systems as a result of work prompted by the Basel II process. Supervision by banking agencies can promote further improvement of those systems and facilitate suitable supervisory responses, but without the skewed incentives that are created when a bank's internal system becomes the basis for determining its minimum capital levels.

Pursue Alternatives to Basel II. The last thing many Basel Committee members want to do is return to negotiations over international capital standards. Understandable as that sentiment may be, I would nonetheless urge our banking agencies to use the breathing space created by adoption and implementing regulations for Basel II to pursue alternatives, both domestically and internationally. The problems with the A-IRB approach more than justify this response. At this juncture, the most promising approach may be a relatively simple international minimum capital rule, accompanied by complementary domestic measures for achieving appropriate bank risk management and by enhanced international cooperation in supervising complex multinational banks.

Specifically, I would suggest that the banking agencies raise with the Basel Committee the idea of an international minimum leverage ratio. As you know, the U.S. leverage ratio requirement is unusual within international banking regulation. On the one hand, as a very simple rule, it cannot be relied on to counteract some of the complicated risks assumed by modern banking organizations. Indeed, it does not even purport to be risk-weighted. But, because of its very simplicity, it is far more transparent in its application, and far less easy to manipulate than more complex regulatory capital requirements. It can serve, as it does today in the United States, as a useful warning sign to regulators and markets. Its application could be fairly easily monitored, domestically and internationally. It would, in short, be a straightforward, uniformly applied minimum capital standard.

The current U.S. leverage ratio does not take off-balance-sheet assets into account and thus should be modified before adoption as an international rule. Other changes might also be worthwhile. But the goal would remain a simple rule. This would not, and could not, be the extent of capital regulation and oversight, either domestically or internationally. I have already suggested one potential complementary mechanism for large, complex banking organizations. Additional supervisory measures could also be developed. It is possible that, over time, some form of an A-IRB or internal credit models approach would itself be a feasible complement. Market discipline might more readily be harnessed to promote regulatory ends. My aim here is not to lay out the results of the international consultative process, but to urge that it be recommenced, with a view to a negotiated arrangement at some later date.

Conclusion

When I began my academic work on Basel II, I was principally interested in some of the unique features of the Basel Committee as an international arrangement. Yet the more I studied it, the more concerned I became that the A-IRB methodology was neither a good approach to domestic regulation of large banks nor a good basis for an international banking arrangement. We could reconvene here each fall for the rest of the decade and, I suspect, our concerns and uncertainties would remain.

But this is not an academic exercise. Our supervisors must regulate and our banks must be allowed to get on with the business of banking. We cannot turn back the clock and start over. The proposal offered by the four large banks to permit a choice between the standardized and internal-ratings based approaches to Basel II is the best suggestion I have heard for moving the process forward without endangering our healthy and profitable banking system. We should not allow regulatory capital levels to fall significantly - hence the need for capital safeguards. At the same time, we should not force banks to spend large sums on ultimately unhelpful regulatory requirements.

I cannot endorse the additional request by some banks to remove the capital safeguards in the banking agencies' Notice of Proposed Rulemaking. However, I believe that there is, despite recent appearances to the contrary, substantial room for a convergence of positions on a long-term approach to capital regulation. Adoption of the four-part plan of action I have put forward here would not only break the immediate impasse; it would also, I hope, create some momentum towards that longer-term solution.

Thank you for your attention. I would be pleased to answer any questions you might have.