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The American Bankers Association (“ABA”) has long supported a comprehensive approach to the regulation of risk-based capital that encompasses minimum capital requirements, supervisory review, and market discipline. The stated goal of the Basel II accord is to arrive at capital requirements that better reflect risk in a bank. However, the Basel II capital requirements as embodied in the banking agencies’ recently promulgated Notice of Proposed Rulemaking (“Proposal”) fall short of that mark. As the Basel risk-based capital rulemakings progress, the ABA urges the Federal banking agencies (“Agencies”) to address three primary concerns:

- First, the capital adequacy framework recently proposed by the Agencies is inconsistent with the international Basel II accord, would place U.S. banks at a competitive disadvantage with banks in other countries, and would impose significant compliance costs on U.S. banks. These issues can be effectively addressed if the Agencies adopt rules that more closely follow the international accord.
- Second, the Agencies should expedite contemporaneous review and revision of the capital rules for the entire banking industry in order to avoid competitive imbalances domestically. It is critical that the Agencies not create winners and losers based on how much capital a given bank must set aside for a particular asset.
- Third, the variety and complexity of the American banking industry call for a menu of capital options in order to achieve the best match of capital with banking operations. A one-size-fits-all approach means a bad fit for most banks.

These points are discussed in further detail below.

I. The Agencies are Diverging from the Basel II Standards to the Detriment of U.S. Banks.

The Basel II accord is intended to promote consistency in international regulatory capital standards. Consistency promotes free competition for banks operating across national boundaries, and it avoids the significant compliance costs that would be associated with different capital regimes in different countries. However, the Agencies have chosen a more restrictive and prescriptive approach than that

being implemented in other countries. The provisions to be applied to large and complex U.S. banks, along with additional limitations that slow implementation, mark a divergence from the standards embodied in the internationally agreed upon Basel II accord.

Under the international accord, three options for approaching credit risk are permitted. These include the Standardized Approach, the Foundation Internal Ratings-Based Approach, and the Advanced Internal Ratings-Based Approach. With respect to operational risk, Basel II provides for the Basic Indicator Approach, the Standardized Approach, and the Advanced Measurement Approach. In the U.S., the Agencies have proposed rules that implement only the Advanced Internal Ratings Based Approach and the Advanced Measurement Approach (collectively, the “Advanced Approaches”) for credit risk and operational risk, requiring the largest banks – the so-called “mandatory banks” – to abide by them.

The Agencies propose to implement the Advanced Approaches in ways that are more restrictive than those embodied in the international Basel II accord. For example, the Proposal requires a bank that sells loans from a single borrower at a discount of five percent or more to treat *all* other loans from the same borrower as being in default, regardless of the situation. Other banks lending to the same borrower would *not* be subject to the same requirement. Such a provision creates artificial differences among competing institutions and contradicts the intent of Basel II.

Furthermore, the Advanced Approaches as proposed contain several limits that would prevent banks from realizing the potential benefits of capital reform. For example, the Proposal involves phasing in Basel II over a three-year period following implementation of the new standards. U.S. banks will be limited during this phase-in period by “transition floors.” These floors last longer than those adopted by other nations, and only U.S. banks must seek permission from regulators to move to the next floor. As a result, banks around the world will have moved on to Basel II long before U.S. banks even begin.

A second limitation involves retention of the leverage ratio. Over the past decade, banks and regulators have made significant advances in risk management techniques. These advances are reflected in the Basel II accord and it is important to review objectively whether the leverage ratio is still necessary in light of the new framework. The leverage ratio likely will require banks to hold more capital than is justified by a risk analysis, creating incentives for banks to acquire riskier assets in order to earn an acceptable return on the excess capital.

Third, the Agencies have promised to make further adjustments to the capital rules if the aggregate capital of banks employing Basel II decreases more than ten percent. This is an arbitrary limit that has no relationship to economic conditions. In strong economic cycles, a drop in required regulatory capital of

ten percent or more may well be appropriate and would not pose any safety and soundness concerns. Conversely, in economic downturns, the amount of required regulatory capital could easily be in excess of the amount required under Basel I. Furthermore, it is entirely possible that a significant decline of risk-based capital for just a few of the banks complying with Basel II could bring the aggregate decline of all such banks above 10 percent. Under such circumstances, it would not be appropriate to penalize all banks complying with Basel II.

The objective of the rulemaking should be to tie capital to risk. Banks do this every day, separate and apart from regulatory capital requirements. Mandatory banks have been using internal models for years and have demonstrated their reliability throughout all phases of the credit cycles. Further, the largest U.S. banks have full-time, resident regulatory examination teams with detailed knowledge of, and access to, the banks' intricate capital management processes. However, if regulatory constraints are not appropriately risk-sensitive, most banks will be forced to run parallel capital systems. One system will be used to report to regulators, while the other system – which will be a better gauge of actual risk – will be used to run the bank. It will be extremely costly for banks to operate in an environment that requires two, disparate capital systems.

As a result of the disparities between the Proposal and the international accord, the U.S. banking industry is likely to realize few, if any, of the benefits that were anticipated at the inauguration of the Basel II exercise. Capital requirements will not be appropriately linked to risk, U.S. banks will be placed at a competitive disadvantage to foreign banks, and U.S. banks will be subject to a costly compliance burden. By being too restrictive, the Agencies would effectively impose a regulatory tax that either would make U.S. banks less able to serve as an economic catalyst in this country or prompt them to engage in risk-taking solely to use the excess capital required by the regulation.

Some, noting that U.S. banks have enjoyed record profitability notwithstanding having to comply with the current capital rules, conclude that the safeguards proposed in the Basel II proposal will not harm the ability of U.S. banks to compete internationally. This conclusion ignores the opportunities lost as a result of inefficient regulation. While U.S. banks have been successful, the relevant question is whether they could be **more** successful under rules that are more effective at tying capital to risk. It is important that the objective be to achieve optimally risk-sensitive capital rules.

It also is important to note that competition and capital flows do not stop at national borders. Even those U.S. banks that have mostly domestic operations will be put at a disadvantage in competing for major business customers who can easily turn to foreign banks operating under more appropriate Basel II rules.

The adverse consequences of the Advanced Approaches as embodied in the Proposal are not confined to the mandatory banks. A bank considering whether to “opt in” to adoption of the new standards likely would find that the compliance burdens far outweigh any benefits. Hence, the Basel II goal of encouraging superior risk management will be significantly undermined.

These detrimental effects of the Proposal can be avoided if the Agencies adopt instead rules that more closely follow the international Basel II accord. By making the capital rules that apply to U.S. banks comparable to those adopted in other countries, the competitive disadvantages that flow from the Proposal would fade, and U.S. banks would have regulatory capital that is a much better match for their risks.

II. The Agencies should expedite contemporaneous review and revision of the capital rules for the entire banking industry in order to avoid competitive imbalances domestically.

If the Agencies were to adopt advanced capital rules comparable to those of the international Basel II accord, this could result in lower capital charges in many instances for the mandatory banks and opt-in banks (collectively, “Basel II banks”). Taken by itself, this could leave much of the rest of the banking industry subject to admittedly out-of-date capital standards and to higher capital retention requirements. As a result, the vast majority of U.S. banks could find themselves at a disadvantage when competing with Basel II banks. Basel II banks could make the same loans as community and regional banks but at a fraction of the risk-based capital assessment. This in turn could tempt Basel II banks to acquire community banks in order to unlock the excess capital they hold.

It is imperative that the Agencies not create winners and losers based on how much capital a given bank must set aside for a particular asset. To maintain competitive balance within the American banking industry, an appropriate update of capital rules is needed for all the community and regional banks for which the more advanced elements of Basel II are excessively expensive and complex. It is essential that each of these rules should require roughly the same amount of capital for the same asset, regardless of the size or complexity of the banks involved.

The original Basel Accord was developed more than fifteen years ago to provide a uniform international regulatory standard specifically for large, internationally active banks. However, the Agencies elected to apply it to every bank in the country regardless of their size. The original accord has never been a good fit for the wide variety of individual circumstances of American banks, particularly the smaller institutions. Now, with multinational adoption of Basel II, the existing risk-based capital regime has

become an archaic, idiosyncratic U.S. standard. In profound irony, the original accord will be applied chiefly to the banks for which it was not intended, those that are not in the ranks of the largest or internationally active institutions. This misappropriation of capital standards needs to be addressed.

The ABA applauds the Agencies on their announced commitment to develop a revised version of the existing capital standards, sometimes called a Basel IA standard. We further support their plan to expedite the schedule for proposing alternatives to the Basel II capital rules so that all options can be reviewed contemporaneously. The recent decision by the Office of Management and Budget (“OMB”) to review the Basel IA proposal of the Office of the Comptroller of the Currency (“OCC”) and Office of Thrift Supervision (“OTS”) jeopardizes the ability of the industry to review the relevant options before submitting comments. Accordingly, we have requested that the Agencies announce their intention to toll the running of the Basel II comment period and establish a new deadline once OMB authorizes the OCC and OTS to publish Basel IA.

The mandatory banks have been working on their Basel II conforming systems for years. If the revised risk-based capital rules for all other banks are applied sequentially to the Basel II Advanced Approaches, then the institutions adopting the Advanced Approaches will be ready to take advantage of their new paradigm while all others will be just beginning to adjust to theirs. These second-stage banks would, as an unintended result of regulatory action, surely lose customers and business to their larger rivals. Therefore, the Agencies need to move forward expeditiously to revise the general risk-based capital standards that will apply to banks not adopting the Basel II approach. This way the entire industry can be prepared to follow standards that are competitively comparable.

Moving up the existing risk-based capital standard revision schedule also will help with acceptance and implementation of Basel II. Accelerating the revision of the rule for the entire industry together would help allay competitive balance concerns voiced in the industry and by governmental leaders and reduce resistance to finalizing Basel II.

III. The variety and complexity of the American banking industry call for a select menu of capital options in order to achieve the best match of effective capital standard with banking institution; a one-size-fits-all approach means a bad fit for most banks.

Prudent changes to the Proposal could make the Advanced Approaches a workable, effective means for determining how much capital is appropriate for the adopting banks. The ABA intends to submit comments to the Agencies that will focus on changes we believe should be made to the transitional

floors, to the continued application of the leverage ratio, to the definition of “default,” and to other areas where the regulators have inappropriately deviated from the international accord. These changes would conform the Advanced Approaches for U.S. banks more closely to those set forth in the international Basel II accord. If the problems highlighted during the comment period can be resolved, we would support adoption of the Advanced Approaches as one option for banks to consider.

In addition to addressing the problems with the Advanced Approaches, the Agencies should provide banks other appropriate risk-based capital options. Giving banks a choice of methodologies for risk-based capital compliance has several benefits, including the following:

- It allows banks to choose among methodologies that are simple and transparent;
- It promotes 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.

One option that should be considered is the Standardized Approach under Basel II. The Standardized Approach for credit risk 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 Agencies approved in June 2004, and those terms and conditions are fully known and understood by the Agencies. With so much work already done on this approach, its inclusion in a menu of capital options for U.S. banks should not require extensive additional work.

The Standardized Approach ties capital charges to factors such as the credit rating of the borrower and the strength of collateral. It also recognizes that prudently underwritten residential real estate loans deserve a lower risk-weighting than is assigned under current rules. While the Standardized Approach to credit risk is not as complex as the Advanced Internal Ratings Based Approach, it is nevertheless an improvement in many ways over existing rules.

Moreover, the Standardized Approach may be an optimal capital standard for many banks. For the mandatory banks, it may offer an appropriate balancing of the benefits of greater risk sensitivity and the burdens of regulatory compliance, while allowing flexibility to accommodate a bank’s latest internal risk management program. For banks considering whether to opt in to the Basel II framework, the Standardized Approach may present a better fit. We appreciate the question in the Proposal about

whether the Standardized Approach should be a part of the U.S. Basel II rules, and encourage the Agencies to develop this option with more particularity as part of the Basel IA proposal.

The Agencies also should continue their efforts to develop a Basel IA approach that provides a meaningful option to Basel II and the Standardized Approach. The current Basel IA initiative was prompted by a recognition that existing capital rules are not sufficiently risk-sensitive for most banks but that the Basel II rules are likely to be too complicated. These concerns remain valid. An appropriate Basel IA standard should provide 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, necessary step in the implementation of the Basel II accord in the United States.

Many of the ideas discussed in the Agencies' Advance Notice of Proposed Rulemaking ("ANPR") concerning Basel IA are potentially very helpful. These include such things as using more "risk buckets" when classifying assets and considering loan-to-value ratios when determining the capital charge for 1-4 family residential mortgage loans. However, if the Basel IA proposal turns out to be largely the same as the Standardized Approach, we would encourage the Agencies to consider other options that would provide more flexibility when determining the appropriate amount of capital based on the quality of a bank's systems.

A fourth option should be to retain Basel I standards for banks with uncomplicated balance sheets. For many banks of this nature, the supervisory and paperwork burden of adopting a new system, even if it could lower the capital requirement, may not be viewed as an efficient use of resources. Hence, the existing Basel I rule could be a prudent standard for many banks and should be retained as an option.

It is important that risk and capital be appropriately linked for all banks regardless of their size, and in such a way as to avoid creating competitive disparities. The efforts to improve the risk sensitivity of regulatory capital requirements should not result in disproportionate compliance burdens. Applying a select menu of reasonable capital standards for banks of all sizes is the best course of action. Just as applying the Advanced Approaches to small banks with uncomplicated balance sheets would result in a bad fit, so too would continuing to apply the existing Basel I program for large, internationally active banks. That principle holds true as well for banks in the middle. One-size-fits-all is likely to be a bad fit for most banks.