



TESTIMONY OF

MAURICE H. HARTIGAN II

PRESIDENT AND CEO

RMA - THE RISK MANAGEMENT ASSOCIATION

BEFORE THE

UNITED STATES SENATE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

JUNE 18, 2003

THE VIEWS EXPRESSED HEREIN ARE THOSE OF THE PRESIDENT AND CEO OF RMA. INDIVIDUAL MEMBERS OF RMA MAY HOLD VIEWS DIFFERENT FROM THOSE EXPRESSED HERE.

**TESTIMONY OF MAURICE H. HARTIGAN II
REVIEW OF THE NEW BASEL CAPITAL ACCORD
UNITED STATES SENATE
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GOOD MORNING, MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. THANK YOU FOR INVITING ME TO APPEAR BEFORE THE COMMITTEE TO DISCUSS THE IMPORTANT WORK UNDER WAY TO REFORM THE 1988 CAPITAL ACCORD, SOMETIMES KNOWN AS THE BASEL ACCORD. MY NAME IS MAURICE HARTIGAN AND I AM THE PRESIDENT AND CEO OF RMA – THE RISK MANAGEMENT ASSOCIATION. RMA IS A MEMBER-DRIVEN PROFESSIONAL ASSOCIATION WHOSE SOLE PURPOSE IS TO ADVANCE THE USE OF SOUND RISK PRINCIPLES IN THE FINANCIAL SERVICES INDUSTRY. RMA PROMOTES AN ENTERPRISE-WIDE APPROACH TO RISK MANAGEMENT THAT FOCUSES ON CREDIT RISK, MARKET RISK, AND OPERATIONAL RISK.¹

¹ Headquartered in Philadelphia, RMA has 3,000 institutional members that include banks of all sizes as well as nonbank institutions. They are represented in the Association by 16,000 commercial loan, credit, and risk management professionals in the 50 states, Puerto Rico, Canada, and numerous foreign cities, including Hong Kong, Singapore, and London. RMA was founded in 1914 and formerly known as Robert Morris Associates.

RMA HAS BEEN ACTIVELY INVOLVED IN THE REFORM OF THE 1988 ACCORD. IN 1999, WE FORMED THE RMA CAPITAL WORKING GROUP, CONSISTING OF THE CHIEF ECONOMIC CAPITAL OFFICERS OF MAJOR BANKING INSTITUTIONS IN NORTH AMERICA. OUR GROUP CONDUCTED RESEARCH TO DEMONSTRATE HOW BANKS USE THEIR INTERNAL RISK RATING SYSTEMS TO ASSIGN ECONOMIC CAPITAL. THE RMA CAPITAL WORKING GROUP HAS PRODUCED A SUBSTANTIAL BODY OF RESEARCH, AND HAS COMMENTED EXTENSIVELY ON DIFFERENT DRAFTS OF THE NEW ACCORD. IT IS CURRENTLY FORMULATING COMMENTS TO THE MOST RECENT BASEL COMMITTEE DRAFT, THE THIRD CONSULTATIVE PAPER. THIS GROUP ALSO PLANS TO COMMENT ON THE FORTHCOMING INTER-AGENCY ADVANCED NOTICE OF PROPOSED RULEMAKING THAT WILL DEAL WITH THE US IMPLEMENTATION OF THE NEW ACCORD.

THE MAIN POINT I WANT TO MAKE TO YOU TODAY IS THAT THE NEW BASEL ACCORD WILL BE A STEP FORWARD FOR THE US AND WORLD BANKING INDUSTRIES, PROVIDED IT IS MODIFIED AS IT IS BEING FINALIZED AND PROVIDED IT IS IMPLEMENTED FLEXIBLY. IT WILL BE A STEP FORWARD BECAUSE IT IS DIRECTIONALLY CORRECT IN IMPROVING THE RISK SENSITIVITY OF REGULATORY MINIMUM CAPITAL ADEQUACY STANDARDS. BUT IT MUST BE MODIFIED TO ENSURE THAT IT IS NOT TOO CONSERVATIVE – THAT THESE ARE TRULY MINIMUM AND NOT MAXIMUM CAPITAL STANDARDS – AND TO ENSURE THAT IT IS NOT TOO PRESCRIPTIVE.

THE PURPOSE OF THE NEW BASEL ACCORD IS TO MAKE CAPITAL REGULATION TRULY RISK SENSITIVE. THE 1988 ACCORD WAS CALLED THE RISK-BASED CAPITAL ACCORD, BUT IT

WAS THAT IN NAME ONLY. THE NEW ACCORD IS DESIGNED TO BE MUCH MORE RISK SENSITIVE. IT WILL REQUIRE ADDITIONAL CAPITAL FOR ACTIVITIES THAT ARE MORE RISKY AND LESS CAPITAL FOR THOSE THAT ARE NOT. THE 1988 ACCORD RELIED SOLELY ON A REGULATORY MINIMUM CAPITAL STANDARD. IN CONTRAST, THE NEW ACCORD WILL BE GROUNDED ON THREE PRINCIPLES OR "PILLARS" AS THEY ARE CALLED: 1) CAPITAL REQUIREMENTS, 2) ENHANCED SUPERVISION, AND 3) GREATER DISCLOSURE. THIS ALONE REPRESENTS A SIGNIFICANT IMPROVEMENT.

NONETHELESS, WE HAVE SPECIFIC CONCERNS IN THIS AREA. PILLAR 1, WHICH DEALS WITH THE CAPITAL STANDARD ITSELF, MUST CONTAIN ASSURANCES THAT BASEL WILL EVOLVE TOWARD A FULL MODELS-BASED APPROACH FOR CREDIT RISK, AND IT MUST AVOID ARBITRARY SPECIFICITY. PILLAR 2, WHICH DEALS WITH THE IMPLEMENTATION OF THE STANDARD THROUGH THE PROCESS OF SUPERVISION, MUST ALLOW REGULATORS ENOUGH DISCRETION TO ACCOMMODATE THE DIVERSITY OF BEST PRACTICES IN RISK MANAGEMENT TODAY. PILLAR 3, WHICH REQUIRES INCREASED DISCLOSURE IN ORDER TO PROVIDE GREATER MARKET DISCIPLINE, MUST ENSURE THAT COMPARABILITY IS MEANINGFUL ACROSS THE VARYING INTERNATIONAL ACCOUNTING REGIMES.

OUR RESEARCH TO DATE SUGGESTS THAT THE NEW ACCORD, AS PROPOSED IN THE THIRD CONSULTATIVE PAPER, WILL REQUIRE MORE OVERALL CAPITAL THAN MANY BANKS' INTERNAL RISK RATING SYSTEMS REQUIRE TODAY, EVEN THOUGH FOR SOME BANKS AND

SOME PORTFOLIOS, THE NEW OVERALL REQUIREMENT WILL BE SOMEWHAT LESS THAN UNDER THE OLD ACCORD.² THIS WILL OFTEN BE INAPPROPRIATE.

THE NEW ACCORD SHOULD REPRESENT A TRUE *MINIMUM* CAPITAL REQUIREMENT. FOR WELL RUN BANKS IN NORMAL TIMES THIS IMPLIES THAT REGULATORY CAPITAL LEVELS SHOULD BE SET BELOW A BANK'S ECONOMIC CAPITAL BASED ON BEST-PRACTICE INTERNAL RISK MEASUREMENT PROCEDURES.

RMA AND MANY OTHERS WITHIN THE INDUSTRY HAVE LONG ARGUED THAT REGULATORY CAPITAL REQUIREMENTS SHOULD BE MORE CLOSELY ALIGNED WITH AN INSTITUTION'S OWN INTERNAL RISK RATING SYSTEMS. BEST-PRACTICE INSTITUTIONS TODAY ASSIGN INTERNAL CAPITAL TO THEIR PORTFOLIOS AND MEASURE PERFORMANCE ON A RISK-ADJUSTED BASIS. DOING SO ENABLES THEM TO BETTER PRICE FOR RISK AND MAXIMIZE SHAREHOLDER VALUE. THUS, GOOD BUSINESS PRACTICES ARE CONSISTENT WITH THE ECONOMIC CAPITAL PRINCIPLES UNDERLYING THE PROPOSED NEW ACCORD.

THE OLD CAPITAL ACCORD REQUIRES BEST-PRACTICE INSTITUTIONS TO MAINTAIN TWO COMPLETELY SEPARATE CAPITAL REGIMES: AN INTERNAL SYSTEM THAT MIRRORS THEIR TRUE RISK PROFILE, AND A REGULATORY CAPITAL SYSTEM THAT IS A SIMPLE, FLAT CAPITAL CHARGE. ADVANCED-PRACTICE INSTITUTIONS DO NOT MANAGE RISK BASED ON THE CURRENT REGULATORY CAPITAL REQUIREMENTS. IT WOULD NOT BE IN THEIR

² All of RMA's research and our formal responses to the Consultative Papers issued by the Basel Committee are available on our Web site at www.rmahq.org. RMA's Securities Lending Committee has also responded to the proposed treatment of securities lending activities, and the work of that Committee is available to the public on our Web site as well. Institutions participating in the research are listed on the Web site and may hold views different from those expressed in this testimony.

SHAREHOLDERS' OR THEIR CUSTOMERS' BEST INTERESTS TO DO SO. THIS FACT HAS CERTAINLY NOT GONE UNNOTICED BY THE REGULATORS. INDEED, THAT IS WHY REFORM OF THE 1988 ACCORD IS UNDER WAY.

FOR BEST-PRACTICE INSTITUTIONS, THE POSSIBILITY TO ALIGN INTERNAL CAPITAL ESTIMATION PROCESSES AND REGULATORY CAPITAL PROCEDURES REPRESENTS A SIGNIFICANT AND MEANINGFUL IMPROVEMENT OVER THE CURRENT SYSTEM. TURNING THIS PROMISING POSSIBILITY INTO REALITY IS NOT AN EASY TASK, HOWEVER. AND THAT IS WHY WE ARE HERE BEFORE YOU TODAY FOR A REVIEW OF THE NEW BASEL ACCORD.

THE PROCESS TO REFORM THE 1988 CAPITAL ACCORD HAS HAD A POSITIVE IMPACT ON THE DEVELOPMENT OF RISK MEASUREMENT AND MANAGEMENT PROCEDURES IN THE FINANCIAL SERVICES INDUSTRY. MOREOVER, THE DIALOGUE BETWEEN THE INDUSTRY AND ITS REGULATORS SURROUNDING BASEL REFORM, WHILE NOT WITHOUT FRUSTRATION ON BOTH SIDES, HAS BEEN USEFUL AND PRODUCTIVE. WHILE OUTSTANDING ISSUES CLEARLY REMAIN, SOME QUITE SIGNIFICANT, CONTINUED DISCUSSION WITH THE INDUSTRY IS ONGOING, AND I WOULD EXPECT THAT TO BE THE CASE THROUGHOUT THE REFORM PROCESS AND INTO THE IMPLEMENTATION STAGE AS WELL. INDEED, IT MAY NOT BE POSSIBLE TO RESOLVE A NUMBER OF SPECIFIC ISSUES WITHOUT AN ACTIVE TWO-WAY DIALOGUE BETWEEN REGULATORS AND THE INDUSTRY AS THE IMPLEMENTATION PROCESS TAKES PLACE.

FURTHER DISCUSSION CAN ONLY HELP PROMOTE INNOVATION AND INVESTMENT IN BEST PRACTICES THROUGHOUT THE INDUSTRY. IT IS FOR THIS REASON THAT THE REFORM PROCESS MUST CONTINUE. HOWEVER, IT MUST BE FRAMED AS A WORK IN PROGRESS. THERE CANNOT BE A PRESCRIBED “END STATE” FOR SOUND RISK MANAGEMENT PRACTICES. OTHERWISE, THE INK ON THE NEW ACCORD WOULD NOT BE DRY BEFORE IT BECAME OBSOLETE, MUCH LIKE THE 1988 CAPITAL ACCORD.

THE QUANTITATIVE ANALYTICS SUPPORTING SOUND CREDIT RISK MEASUREMENT AND MANAGEMENT ARE STILL EVOLVING. MANY OF THESE EMERGING PRACTICES WERE BORN OUT OF THE LAST ECONOMIC DOWNTURN. THE RESILIENCE OF THE FINANCIAL SERVICES INDUSTRY OVER THE PAST THREE YEARS SHOULD NOT GO WITHOUT COMMENT. MANY HAVE CREDITED THE INDUSTRY’S SUCCESS TO THE BETTER RISK MANAGEMENT PRACTICES ESTABLISHED OVER THE PAST DECADE. I WOULD HAVE TO AGREE.

ONE WAY TO LOOK AT THE NEW ACCORD IS THAT IT IS AIMED AT BRINGING CAPITAL ADEQUACY STANDARDS FOR CREDIT AND OPERATIONAL RISK CLOSER TO THOSE FOR MARKET RISK. FOR SOME TIME, MARKET RISK HAS HAD A WELL-ESTABLISHED LANGUAGE AMONG PRACTITIONERS, STRONG ANALYTICS, AND A ROBUST DISCLOSURE FRAMEWORK TO SUPPORT IT. IT IS FOR THIS REASON THAT AMENDMENTS TO THE 1988 CAPITAL ACCORD WERE ADOPTED IN 1995 TO ACKNOWLEDGE THE INDUSTRY’S ADVANCEMENT IN THE FIELD.

CREDIT AND OPERATIONAL RISK MANAGEMENT ARE STILL EVOLVING TO CATCH UP WITH MARKET RISK MANAGEMENT. THE PRACTICE OF CREDIT RISK MEASUREMENT AND

MANAGEMENT WILL NO DOUBT BENEFIT GREATLY OVER THE NEXT TWO YEARS AS NEW DATA BECOME AVAILABLE TO POPULATE QUANTITATIVE CREDIT RISK MODELING SYSTEMS. OPERATIONAL RISK MEASUREMENT IS A YOUNGER FIELD, AND IT IS MAKING STRIDES ON THE BACK OF OUR ACHIEVEMENTS IN CREDIT AND MARKET RISK.

GIVEN THE NEWNESS OF THE FIELDS OF STUDY SURROUNDING CREDIT AND OPERATIONAL RISK MANAGEMENT, IT IS NATURAL THAT REGULATORS SHOULD BE PRONE TO CONSERVATISM. BUT TOO MUCH CAPITAL IS JUST AS BAD AS TOO LITTLE CAPITAL. TOO MUCH CAPITAL WILL DRIVE DOWN THE RISK-ADJUSTED RATES OF RETURN ON A PARTICULAR BUSINESS LINE AND CAUSE BANKERS TO LEND LESS THAN THEY OTHERWISE WOULD AND SHOULD. THIS IS NOT A GOOD THING EITHER, FOR THE SHAREHOLDERS OF THE BANK, THE LOAN CUSTOMERS OF THE BANK, OR THE GENERAL ECONOMY.

FURTHERMORE, IN OUR OWN REVIEW OF BASEL II, WE FIND THAT SOME OF THE NEW REQUIREMENTS ARE WRITTEN IN A VERY PRESCRIPTIVE FASHION THAT DOES NOT LEND ITSELF TO ALLOWING INDIVIDUAL BANKS TO EMPLOY A DIVERSITY OF BEST PRACTICES. WITHOUT SUCH DIVERSITY WE CANNOT HAVE CONTINUED EVOLUTION OF BEST PRACTICES, AND WITHOUT EVOLUTION WE COULD NOT HAVE HAD THE IMPROVEMENTS IN RISK MEASUREMENT THAT HAVE OCCURRED OVER THE PAST DECADE.

I WOULD NOW LIKE TO TOUCH ON TWO AREAS, WHICH ARE SOMEWHAT MORE TECHNICAL IN NATURE, ABOUT WHICH WE HAVE GREAT CONCERN AT PRESENT. FOREMOST IS THE ADOPTION BY BASEL OF THE SAME SORT OF CREDIT RISK MODEL AS USED BY ADVANCED

BANKS. A KEY PARAMETER OF THESE MODELS – THE DEGREE TO WHICH LOAN LOSSES ARE CORRELATED – IS SET BY BASEL, NOT BY THE EMPIRICAL RESEARCH OF BEST-PRACTICE BANKS. IN SOME CASES, SUCH AS CERTAIN RETAIL LOAN PRODUCTS, THIS CRITICAL PARAMETER HAS BEEN SET TOO HIGH BY BASEL, CAUSING THE REGULATORY CAPITAL MINIMUMS TO BE TOO HIGH. THIS IS WHY RMA HAS CONSISTENTLY STATED IN ALL OUR PAPERS TO THE BASEL COMMITTEE THAT, "WE BELIEVE STRONGLY THAT THE INTERNAL RATINGS BASED (IRB) APPROACH MUST BE FOLLOWED WITH A FULL INTERNAL MODELS APPROACH TO CAPITAL."

SECOND, RMA ALSO HAS REPEATEDLY ARGUED THAT THE BASEL DEFINITION OF CAPITAL SHOULD BE CHANGED TO CONFORM TO THE DEFINITION USED BY THE INDUSTRY. INDEED, BASEL II WILL RUN INTO PROBLEMS TO THE EXTENT THAT THE BASEL VIEW OF CAPITAL DIFFERS SUBSTANTIALLY FROM THE VIEW OF ECONOMIC CAPITAL HELD BY THE INDUSTRY. IN THE INDUSTRY VIEW, ECONOMIC CAPITAL IS REQUIRED ONLY FOR UNEXPECTED LOSS (KNOWN AS UL). THE BASEL COMMITTEE HAS PROPOSED THAT BOTH UL AND EXPECTED LOSS (KNOWN AS EL) BE INCLUDED IN BANK CAPITAL. RMA DISAGREES. FOR PURPOSES OF ESTIMATING ECONOMIC CAPITAL AND CAPITAL ADEQUACY, EL IS COVERED BY EARNINGS (SPREAD AND FEES, NET OF EXPENSES), AND WE BELIEVE THAT IT IS DOUBLE COUNTING TO INCLUDE EXPECTED LOSSES IN CAPITAL. INDEED, IF EL IS INCLUDED IN BANK REGULATORY CAPITAL, IT WILL CLEARLY DISADVANTAGE BANKS WITH THEIR NONBANK COMPETITORS.

RMA HAS ADDITIONAL TECHNICAL CONCERNS SPECIFIC TO THE THIRD CONSULTATIVE PAPER THAT WE WILL ADDRESS IN OUR FORMAL RESPONSE.

TO CONCLUDE, I WOULD LIKE TO REITERATE RMA'S BELIEF THAT THE REFORM PROCESS HAS HELPED ADVANCE THE PRACTICE OF SOUND RISK MEASUREMENT AND MANAGEMENT WITHIN THE INDUSTRY. RMA IS HOPEFUL THAT THE NEW CAPITAL ACCORD CAN BE STRUCTURED TO ENCOURAGE AND ENHANCE CONTINUED INDUSTRY INNOVATION AND THAT IT WILL RECOGNIZE THE BENEFIT THAT DIVERSITY OF PRACTICE WITHIN THE INDUSTRY PROVIDES.

MUCH GOOD WORK HAS BEEN DONE IN CONJUNCTION WITH THE NEW ACCORD. IT HAS HELPED FOSTER VALUABLE RESEARCH THAT HAS CONTRIBUTED TO INDUSTRY INNOVATION. IT HAS ALSO FOCUSED THE INDUSTRY AND ITS REGULATORS ON THE NEED FOR ADDITIONAL RESEARCH. DATA LIMITATIONS REMAIN IN A NUMBER OF KEY AREAS, AND THIS IS LIKELY TO BE THE CASE FOR SOME TIME. AGAIN, THIS ONLY REINFORCES THE FACT THAT DEVELOPMENT OF THE NEW ACCORD MUST BE AN ONGOING PROCESS.

REGULATORY CAPITAL STANDARDS MUST EVOLVE OVER TIME AS PRACTICES WITHIN THE INDUSTRY EVOLVE. OTHERWISE, THE INDUSTRY AND ITS REGULATORS WILL CONTINUE TO FACE THE SAME LIMITATIONS EMBEDDED IN THE CURRENT ACCORD.

IN OUR VIEW, THE ONLY WAY FOR THIS GOAL TO BE ACHIEVED IS TO ALLOW FOR THE DEVELOPMENT, OVER TIME, OF A FULL INTERNAL-MODELS-BASED APPROACH TO BANK

CAPITAL. THE PROPOSALS CONTAINED WITHIN THE THIRD CONSULTATIVE PAPER, SUBJECT TO THE SPECIFIC CONCERNS WE WILL BE ADDRESSING SHORTLY, CAN REPRESENT A NECESSARY START TO THIS PROCESS. THANK YOU, AND I WOULD BE HAPPY TO ANSWER ANY QUESTIONS THAT YOU MIGHT HAVE.