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Mr. Chairman, members of the Committee, it is a distinct honor and privilege to appear before you today to discuss the implications of the proposed Basel II capital accord currently under consideration by U.S. regulators and those in other major countries.

I will explain my rationale below, but let me say up front that I have grave reservations about the proposed Basel II capital regime. I believe it carries the potential to do enormous harm to the U.S. banking system, which is the strongest, most profitable, and most innovative banking system in the world.

No regulator, legislator, or banker who lived through the banking crisis of the 1980s in this country can ever forget the lessons of that period – one of which is that capital very much matters. U.S. regulators and bankers have spent the last quarter century building the best banking system in the world. We should not risk everything we have worked so hard to create by relying on theoretical risk models to determine the appropriate level of capital for our banks.

International regulators developed risk-based capital rules (called Basel I) in the late 1980s to apply to all banks. They offered two primary justifications for Basel I: a) capital rules should apply uniformly to banks

throughout the world in order to level the playing field, and b) capital requirements should correspond to the level of risk in individual banks. One could hardly quarrel with these objectives, although it was far from clear that Basel I was the most appropriate way to achieve them.

Despite its stated objectives, Basel I has not come close to fostering parity in worldwide capital standards. At year-end 2004, the twenty largest banking companies outside the U.S. had a median capital-to-assets ratio of 3% compared to the 6% median ratio (excluding goodwill) of the twenty largest U.S. banking companies.

The capital level of these foreign banks was below where the capital of large U.S. banks was in the late 1970s, before U.S. regulators began a major push to increase large bank capital levels. Only two of the twenty largest foreign banks met minimum U.S. standards at year-end 2004.

Despite their overwhelming use of leverage, the median return on equity of these large foreign banks was comparable to the median return of major U.S. banks. In short, large U.S. banks have much stronger balance sheets and enjoy much higher operating margins than their foreign counterparts.

Most career regulators in the U.S. were skeptical about Basel I from the beginning. They were reluctant to place too much faith in rigid formulas and doubted the claims that Basel I would bring about international parity.

As a result of these concerns, U.S. regulators overlay on Basel I a minimum capital to assets standard (*i.e.*, leverage ratio) to guard against potential flaws in Basel I and to prevent capital from falling too sharply. Moreover, U.S. regulators retained the ability to override the Basel I standards and demand more capital whenever warranted. I have no doubt that the comparative strength of the U.S. banking system today is due in no small part to the fact that U.S. regulators did not succumb to the pressure to lower their regulatory standards to international norms.

Almost from the day Basel I was adopted, the Basel Committee at the Bank for International Settlements began agitating for a more "sophisticated" version of the regime, which has come to be known as Basel II. The rationale behind Basel II is that the largest banks in the world are too complex for the relatively simple capital standards of Basel I. Champions of Basel II believe the largest and most sophisticated banks have the ability to construct models to assign capital to their various risk exposures and that these models will be superior to any rigid tests the regulators might apply.

Basel II is very controversial, as one might imagine. My major concerns about Basel II are that:

- **<u>Basel II is based on inadequate and unreliable data</u>. No large bank has detailed information on losses going back as much as ten years. It is virtually impossible to build reliable models with such a paucity of information, particularly when the decade that the available information covers is the most prosperous in banking history. Moreover, most of the large banks barely resemble what they looked liked ten or fifteen years ago. They are amalgamations of countless mergers of disparate cultures, businesses, and information systems. How one could build a reliable model based on the performance of a business that did not exist fifteen years ago is difficult to fathom. Adding to the confusion, Basel II expects banks to build models for "operational risks." There are two categories of operating risks: a) those you can predict, price, and insure against, and b) those that are not predictable. Losses of the first type have never been a systemic problem in banking, and losses in the second category cannot be modeled.**

- **Basel II will be used to reduce large bank capital ratios and either place smaller banks at a competitive disadvantage or force regulators to lower smaller bank capital ratios. Neither option is acceptable public policy. The regulators conducted a Qualitative Impact Study (QIS4) on Basel II earlier this year, which produced some very disturbing results. QIS4 indicated that Basel II would allow capital levels to drop by at least 26% at half of the big banks, some falling by as much as 50%. The regulators responded to this, in part, by rushing out with proposed revisions to Basel I, which will presumably allow small-bank capital to decline. Alice in Wonderland would love it, but no self-respecting bank supervisor should. I do not believe a compelling case has been or can be made for reducing capital in the banking system.**
- **Basel II is so complex it cannot be adequately understood by senior bank managements, boards of directors, regulators, or the public. I have been in the banking world all of my adult life and served at the FDIC for nearly eight years. Moreover, I have served on the boards of three financial institutions. I think I know something about what it takes to run a bank right and why**

banks fail. The good ones have very good and experienced managements, strong and independent boards of directors, and a healthy respect for what can go wrong. They diversify their risks, put in place strong control systems, maintain solid balance sheets, and are always asking themselves what will happen if their assumptions are flawed. Running a successful bank (and successfully regulating banks) is an art that uses modeling and other forms of science as tools. Basel II employs exceedingly complex models (constructed largely by economists and mathematicians who have never made, much less collected, a loan), which very few people in any bank or any regulatory agency will understand. Making matters worse, Basel II will likely foster complacency and a false sense of security, as some bank managers and boards of directors and even some analysts place unwarranted reliance on the models. If we allow Basel II to elevate questionable science well above the art of management, someday somewhere we almost certainly will pay a big price. We need look no further than the debacle at Long Term Capital Management in 1998 to see what mischief can be caused by

> "brilliant" mathematicians and Nobel Prize winning economists who are given free rein to make huge bets based on their models. The Federal Reserve found it necessary to pressure 14 banks and brokerage firms to invest nearly $4 billion in new equity to prevent LTCM's collapse and avert a possible panic in the worldwide financial markets.

All models, of necessity, look backward – *i.e.*, they use historical data to predict future events. They are accurate, most of the time, if properly constructed and manipulated. But they can result in spectacular failures when they are poorly constructed, use inadequate data, or rely on false assumptions.

Large banks pronounced with great certitude in the 1970s and early 1980s that loans to less developed countries were riskless because sovereign nations could not afford to default and thereby lose their access to international credit markets. Had Basel II existed then, I suspect the risk weighting assigned to sovereign debt would have been close to zero.

I participated in serious and urgent interagency planning in 1984-85 on how to handle the potential simultaneous collapse of the largest U.S. banks in the event of widespread defaults on sovereign debt. Later in the 1980s

Citibank, alone, charged off some $3 billion of LDC loans in one fell swoop. So much for theories and models.

In important ways, Basel II is *deja vu*. The regulators developed a three-tier system for capital adequacy in the 1970s. Community banks were required to maintain capital equal to at least 8% of assets. Regional banks were allowed to go as low as 6% on the theory they were better managed and more diversified, and their size made them less vulnerable to catastrophic fraud losses. Money center banks had no minimum standard – they were okay so long as they did not get out of line with their peers.

Believe it or not, the theory advanced by both banks and top regulators was that capital was not particularly relevant in banks as large and sophisticated as the money center banks. The typical money center bank had capital in the range of 3% during this period, with a couple falling below 3%.

The FDIC, during my tenure, regarded it as fundamentally unfair to require smaller banks to maintain more capital than larger banks. Of even greater concern was the increasingly heavy reliance of larger banks on volatile money market sources of funding. We were concerned that at the first sign of trouble this money would flee, rendering a bank helpless. We

believed that a strong balance sheet was of even greater importance in banks with volatile funding.

The debate among banks and regulators was heated, not unlike today. The theories went out the window in 1984 when Continental Illinois, the eighth largest bank in the country, with one of the lowest capital ratios, lost nearly half of its funding virtually overnight.

It was all the FDIC and Federal Reserve could do to stem the outflow and keep the infection from spreading to banks throughout the world. Together, these two agencies advanced in the range of $20 billion to Continental Illinois, and the FDIC took the unprecedented step of guaranteeing that no creditor of Continental Illinois would suffer any losses or even any delay in receiving its money.

Capital was no longer a theoretical exercise. The regulators quickly agreed that no bank, no matter how seemingly strong and well run, would be allowed to maintain less than 5% tangible equity to assets. Banks would be required to maintain capital above that level based on a case-by-case evaluation of risk through the bank supervisory process.

Basel I was developed a few years later to quantify capital measures to a greater extent. While I have never been a fan of Basel I, at least U.S.

regulators maintained a minimum capital to assets standard and Basel I did not discriminate based on the size of the bank.

Some argue that a U.S.-imposed capital floor places U.S. banks at a disadvantage vis-à-vis foreign banks. This argument was advanced in the 1970s and 1980s, particularly with respect to the Japanese banks, which were growing with reckless abandon and comprised nearly all of the ten largest banks in the world. We hear little about the Japanese banks today, except that they are a drag on the Japanese economy. They operated with little capital, had very low profits, and pursued growth for growth's sake. This business model cannot be sustained indefinitely.

I have not found a single professional bank supervisor who is enthusiastic about Basel II. For that matter, I have not found a single bank CEO who is enthusiastic about Basel II. Indeed, I have spoken with large bank CEOs who complain that Basel II is inferior to their own procedures, which give great weight to seasoned bankers using their judgment. They will implement Basel II if required to do so by their regulators, but they intend to continue to rely on their own models and procedures, which have withstood the test of time through various business cycles.

Capital regulation, in my judgment, should be simple and easily understood. It is foolhardy to adopt a capital regime that will be virtually impossible for senior managements, boards of directors, regulators, and market participants to understand.

There is nothing wrong with the current capital regime in the U.S. that cannot be fixed with some relatively simple modifications to Basel I. Moreover, it is critically important that the leverage ratio and other capital tests be maintained at their current levels.

This is not to say that the Basel II exercise has been for naught. Basel II-type models no doubt provide useful information to the managements of banks and their regulators. Banks should be encouraged to develop and improve such models. But the last thing U.S. regulators should do is engage in a "competition in laxity" with supervisors in other countries by lowering U.S. capital standards to international norms.

I thank you again for providing this public forum on one of the most profound public policy issues currently confronting our nation's banking system.