Statement of L. William Seidman
Basel II
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Mr. Chairman and Members:

Thank you for inviting me to this important hearing. I haven't been before this distinguished Committee for a long time, so please excuse me if I am a little rusty.

Basel II has been billed as an important safety and soundness initiative that is needed to correct the deficiencies of Basel I. Basel II will force banks to hold capital, it is said, for the hidden and undercapitalized risks Basel I allowed them to take.

I was a part of the delegation at Basel I, which had as its <u>principal objective</u> creating common capital minimums for banks around the world. It has achieved that objective. Now Basel II wishes to improve that minimum standard through use of economic models to evaluate risk.

This is a good sentiment—however, unfortunately, as the agencies announced in April 2005, the results of a quantitative impact study (QIS-4) of proposed Basel II showed material reductions in minimum required capital for the population of U.S. institutions that submitted their capital estimates for the study. The study showed a 15.5 percent decline in the average bank's minimum required capital and more than half of the participating banks posted declines in excess of 26 percent. Subsequent studies produced by the Federal Deposit Insurance Corporation suggest that minimum risk-based capital standards at many Basel II eligible banks could fall far below the leverage standards set by Prompt Corrective Action (PCA) for well-capitalized banks. The original intent of Basel II was to more closely align minimum regulatory capital with actual risk, not to materially reduce overall capital levels within the banking system.

The QIS-4 study also showed a significant amount of dispersion in minimum capital requirements across institutions and across different portfolio types. Some dispersion in capital results may be expected because the Basel II framework allows for a significant degree of subjectivity in developing inputs to the capital risk formulas. However, the substantial variance shown in QIS-4 results for categories that should be fairly similar among different institutions—retail lending for example—raise questions as to the prudence of adopting a capital regime that results in such <u>a wide range of perceptions of risk across banking institutions</u>.

<u>It is far from certain that the risk measurement systems in banks have become so precise that they can operate safely at reduced capital margins mandated by Basel II and calculated by banks in the QIS-4 study</u>. Compared to Basel I, the Basel II capital standard may better align capital with the risks taken by banks, but the new standard is far from foolproof. The Basel II standard omits some significant risks faced by banks. <u>Interest rate risk was a key part of the early stages of banking and the thrift crises of the 1980s, yet the Basel II standards do not cover interest rate risk. The Basel II capital standard is also based on estimates from the banks' own data. Make no mistake, these are estimates and are subject to errors</u>. Moreover, Basel II uses these imperfect estimates

in a capital formula that, while complicated and derived from financial theory, is almost certainly an oversimplification of the actual risks taken by banks. So can we be reasonably sure that the Basel II standards would provide sufficient capital for banks? Not in my judgment.

We learned a number of lessons during the bank and thrift crisis years of the late 1980s and early 1990s. One of these lessons is that even sophisticated models can prove to be wrong when faced with unanticipated volatility and changing conditions that invalidate bank model assumptions. Models calibrated to fit performance in good times often will perform badly when market conditions deteriorate. Model risk, an unavoidable by-product of sophisticated risk measurement practices, underscores the importance of retaining capital safeguards, such as the leverage ratio and Prompt Corrective Action minimum equity capital standards.

While the details of the agencies' QIS-4 analysis have not yet been made public, there are some publicly disclosed Basel II minimum capital level results that can be compared to existing regulatory benchmarks, and these comparisons should raise concerns. My specific concerns focus on minimum capital requirements for residential mortgages. You are aware no doubt that some prominent officials in the banking regulatory community have been vocal about the need to raise minimum regulatory capital requirements for the housing GSEs, Fannie Mae and Freddie Mac, which currently are about 2.5 percent for mortgages held on the GSE balance sheets. There seems to be a growing consensus in these halls that the safety and soundness of the financial system may be enhanced by increasing the minimum capital position that GSEs are required to maintain. At the same time that bank regulators have weighed in on GSE regulation, a recent study by the Federal Reserve Board[1] stated that the Basel II minimum capital requirement for GSE conforming mortgages held in banks would be below 50 basis points. I fail to understand how a bank regulator may reconcile these two positions. Common sense dictates that if 2.5 percent is too low for mortgages held in the GSEs, then it must also be too low for mortgages held in banks.

I am concerned by reports that Basel II may result in significantly lower risk-based capital requirements for many of the largest U.S. banks. The Basel II process requires banks to calculate expected defaults and losses from these defaults. Regulatory guidance notwithstanding, it seems possible that Basel II banks' may use their experience over the past few very good years to make these assessments and this may lead a regulatory capital minimum that is too low in the case of bad times. My experience taught me that the minimal equity ratios prior to the banking crisis, then around 4 percent in large banks, were grossly inadequate for the problems that followed. At least two of our largest banks would have failed if there had been the slightest reduction in capital minimums. I don't know where Basel II capital levels will actually be, but I fear that using the extraordinarily benign recent period to calculate future risk will result in banks that are systematically undercapitalized when troubles arise.

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[1] "An Analysis of the Potential Competitive Impacts of Basel II Capital Standards on U.S. Mortgage Rates and Mortgage Securitization," by Diana Hancock, Andreas Lehnert, Wayne Passmore, and Shane M. Sherlund (HLPS).

To their credit the regulators are saying they are not comfortable with these QIS-4 results and would not allow banks to operate at these levels of capital. The regulators indicate they will keep the leverage ratio and get around to fixing the Basel II formulas later.

Maybe they will. Meanwhile, we are going to see a lot of screaming from U.S. banks because they are putting systems in place—at great expense—that will be, for most of them, irrelevant to determining their overall capital. U.S. financial institutions believe they are already constrained by our leverage ratio, unlike their foreign counterparts. The regulators, however, do not believe low capital is a competitive advantage, quite the opposite. Our banks are not only well capitalized; they earn record profits year after year. But those banks who do measure performance by their current return on equity probably are going to believe we have given the rest of the world's banks a huge advantage.

That is why I fear Basel II is putting in place a dynamic that cannot be controlled, and will ultimately lead to significant reduction in the capital of our banking system, and significantly increase the cost of the federal safety net. I do not doubt the good intentions of the regulators today who say they will keep this process under control. However, they cannot control the actions of future agency heads. In addition, those agency heads are going to be under tremendous pressure because of what the regulators are doing today.