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Testimony of
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The Development of New Basel Capital Accords

Good morning, Chairman Shelby, Senator Sarbanes, and members of the committee. My name is Katherine Wyatt. I head the Financial Services Research unit at the New York State Banking Department. I have followed the development of Basel II for the Department since 2000, studied the possible effects of the simpler approaches under Basel II, and worked with my federal counterparts in analyzing banks' implementation programs for Basel II. I appreciate the opportunity to testify today, and ask that a copy of my written statement be included in the record.

I am speaking to you today because I am very concerned that adhering to the proposed timetable for implementation of Basel II in the U.S. will lead to far-reaching changes in the how we measure capital without sufficient understanding of their possible consequences.

Although the New Basel Capital Accord (Basel II) has been discussed in the U.S. since 1999 (at least) there has been insufficient study of its impact on the U.S. banking system, in part because the proposal itself has changed over time, and in part because the federal banking agencies decided to restrict its implementation to the most complex approach and to impose it on only the largest internationally active banking organizations. For example, the best study we have, the fourth Quantitative Impact Study, involved about 20 large internationally active banks and used a version of the Basel II proposal that did not have important details that have been promised for the Basel II NPR, due in Q1 2006.

The banking system in the U.S. comprises about 9,000 different institutions and is rich in different-sized banks with different business models. Because we have only considered Basel II in terms of large complex internationally active institutions, we don't know what the competitive impact of Basel II will be. We don't know what the effect of large banks calculating capital requirements one way, while smaller banks in the same market calculate requirements another way will mean. We don't know what the effect on smaller banks that are public companies and are concerned with return on equity will be if their competitors are allowed to hold less capital. We must carry out a comprehensive impact study – across the entire banking system – before regulations are adopted that could have far-reaching effects for banks and their borrowers.

The federal agencies plan to finish the rule-making process for Basel II, conduct a year of parallel run of current requirements and Basel II, and to have Basel II in effect, all by January 1, 2009. They also aim to have the Domestic Capital Modifications for non-Basel II banks ("Amended Basel I") in effect on January 1, 2009. I am afraid that pushing ahead to complete the rulemaking process for two complex proposals in less than three years will not allow time for essential review of either.

The Basel II Notice of Proposed Rulemaking will have been in development for 2½ years when it is released; we need sufficient time to study this complex proposal. It will be very important to look at Basel II and the Amended Basel I proposals side-by-side, and to study their impact on the U.S. banking system. I am concerned that supervisors will not have enough time to consider the possible consequences of these sweeping changes before they become effective -- and before revision is much more difficult.

It is true that the agencies have included three years of "floors" in their implementation schedule. There will be graduated limits on capital requirements, and banks will be able to move fully to Basel II only at the end of these "floor" years. However, I believe it will be very difficult to make fundamental changes in Basel II after the January 2009 effective date. Banks that adopt Basel II in 2009 will already have made substantial investments in systems and data collection processes, and will surely object strongly to making changes after the effective date.

The Agency projection also assumes that all the necessary documentation for supervision of banks following these revised regulations -- guidance, reporting requirements, and examination procedures -- will be developed in this very short period of time.

I believe that there are two large gaps in our understanding of the impact of Basel II that must be addressed before we move to a Final Rule for either Basel II or Amended Basel I.

First, we don't know what the actual level of capital will be under Basel II for any given bank, or across all Basel II banks. Preliminary QIS 4 results showed a broad range of required capital amounts, even for similar portfolios. Also, Basel II has changed over time; the agencies' timetable seems to involve going ahead with implementation without an impact study of the fully specified proposal. Even more importantly, since capital requirements under Basel II are based on outcomes of mathematical models, we need time to develop rigorous technical guidelines for parameter estimation and tests of data sufficiency, to ensure that required levels of capital are adequate.

The second large gap in knowledge comes from the fact that we have not addressed the changes that may be brought by Basel II (and Amended Basel I) across the entire banking system. Basel II's impact in the U.S. has been studied primarily on large complex banking institutions. However, we haven't fully studied the competitive effect of Basel II on the close to 9,000 non-Basel II banks in the U.S. The Amended Basel I proposal for non-Basel II banks was released only last month, and it is essential that the effects of these two proposals be studied side-by-side.

Use of Models in Calculating Capital Requirements

I would like to speak first about banks' Basel II capital calculations. Under Basel II, capital requirements for credit exposures are based on the outcomes of a particular mathematical model of default specified by supervisors. This supervisory model is applied to complicated portfolios, with a host of adjustments, specifications, exclusions, and exceptions that grew out of attempts to reconcile the model results with existing bank portfolios and existing international bank regulation. (The final U.S. version of these adjustments and specifications should be released early next year.) Basel II banks provide their own estimates of probability of default, loss given default, exposure at default, and maturity as inputs to the Basel II formulas; these parameter estimates depend on the data and other models used by the bank.

A key premise of implementation of Basel II is that banks will have enough reliable data to produce rigorous results from the model. I think many would agree with me that this is often not the case. The variation in required capital estimates for similar exposures found in QIS 4 is quite possibly due to problems of insufficiency of data. We also need to make sure that the modeled capital requirements are adequate when times are bad – the history of the last several years in the U.S. is of good times.

In contrast to the treatment of credit risk, Basel II allows banks to choose their own model to calculate capital requirements for operational risk. Here, even more variation in results is possible, particularly since there are even fewer data for operational loss events than for credit losses. The Basel II ANPR advises banks to use "expert opinion" scenarios to fill out data points in their modeling, thus providing even more opportunities for selection in modeling techniques.

Unfortunately, Basel II could be gamed by choosing the modeling techniques and data sets that will produce the lowest capital requirements.   As well as a very broad range of required capital, preliminary QIS 4 results showed decreases as great as 74% for some bank portfolios. The strong possibility exists, also, that as the distance between risk-based capital requirements and current leverage ratio under prompt corrective action (PCA) capital requirements grows, there will be increased pressure on bank regulators to drop the leverage ratio requirements. For many large banks, satisfying the well-capitalized leverage ratio is already the constraining capital requirement, rather than meeting risk-based capital ratios.

The bank supervisors I've talked with are very worried at the prospect of dropping PCA requirements – they remember other times when banks' predictions about the future did not come true. They also point to their experience that well-capitalized banks are profitable banks, can enjoy lower costs of funding, and more easily weather economic downturns.

I am concerned that without direction from supervisors, capital requirements could differ widely according to the parameter estimation methods used by banks, and depending on banks' own data sources. It is essential that the schedule for implementation allows enough time for supervisors to work with bank models, to understand different parameter estimation techniques, and to gauge sufficiency of data. Supervisors will then be able to develop necessary technical guidelines for the estimation process and to set the restrictions and constraints necessary to ensure adequate required capital. If this time is not allowed, there is a real danger that the estimation techniques "most large banks choose" will become the de facto “best practices.”

Allowing this supervisory review period will also ensure that the necessary examination procedures and guidance will be developed, both for Basel II and Amended Basel I. We need time to understand and assess these proposals, and once they are accepted, we need time to develop examination materials, to provide necessary training for examiners, particularly in the supervision of Basel II banks, and to provide support for bankers.

It can take several years for a bank to develop the systems necessary for adoption of Basel II. Some of the largest banks have already begun this process, in order to be able to adopt Basel II at its effective date. I am concerned that maintaining the current timetable will intensify pressure to keep the Basel II proposal "open" enough so that banks that have begun implementation projects will not have to make radical changes. This could make it very difficult to institute material changes in the future, when banks have committed even more sizeable resources to their Basel II systems. We don't know enough now about the consequences of Basel II to go ahead, in an attempt to justify the expenditures a few banks have already made.

Impact of Changes in Capital Requirements across U.S. Banking System

Both bankers and supervisors are concerned about the impact of Basel II on the U.S. banking system. As pointed out in a letter sent by the Conference of State Bank Supervisors to the Federal Agencies in September of this year,

> "Implementing the risk-based capital requirements depicted in the recent studies could have profound competitive implications and significantly harm the banking

> industry in general and non-Basel II banks in particular. As proposed, Basel II creates significant differences between capital requirements of banks that adopt Basel II and those that do not. The current approach reduces the capital large institutions hold for mortgages and small business loans, among other assets. In a very practical sense, the reduced capital requirements would provide a pricing advantage for the larger institutions. It will be difficult for smaller banks to compete for mortgages and small business loans and certainly difficult for these institutions to hold such assets in their portfolio. In a competitive economy, eventually market forces will likely drive these assets from smaller banks toward the Basel II adopting banks, requiring non-adopting banks, the vast majority of which are small community banks, to move to higher-risk areas of banking.
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> "In addition, with substantially lower capital requirements, larger institutions could acquire community and mid-tier banks without much cost involved by immediately lowering the acquired bank's required capital to a level that is allowed by Basel II banks. The lower capital requirements and the magic of the current Basel II mathematics promote the incentive for consolidation within the banking industry."

CSBS strongly urged the federal banking agencies "to conduct further analysis of potential capital changes that would ensue from adopting the current Basel II proposal."

I'm afraid that the publicly available analysis does not adequately answer these concerns. The Federal Reserve has posted on its website several "White Papers," covering some Basel II portfolios and some of the competitive issues raised by the original "bifurcated" regime proposed by the agencies. However, these papers are based on Basel II circa 2003, and both the Basel Committee and the federal agencies have made changes to their proposals since then. The new Amended Basel I proposal, of course, is not considered at all in this research. The "White Papers" suggest that the impact on non-Basel II banks may be minimal, but these papers are not definitive, and other authors have disagreed with their findings.

We need to have a much better understanding of the consequences of Basel II before it is implemented. We should take the time now – both federal and state banking regulators – to fully test the impact of Basel II and Amended Basel I proposals. In this way, we can work to safeguard the soundness and profitability of the banking system and ensure that U.S. borrowers will continue to have the access to capital that a strong U.S. banking system affords them.

I hope that these remarks are helpful to the Committee and would be pleased to answer any questions that you have.