

Testimony of

Jim Garnett

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Committee on Banking, Housing and Urban Affairs

Of the

United States Senate

September 26, 2006



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Mr. Chairman and members of the Committee, my name is Jim Garnett. I am the Head of Risk Architecture for Citigroup and in this capacity I am responsible for implementation of the Basel II Capital Accord for Citigroup within the United States and other countries in which Citigroup operates. Citigroup is a member of the American Bankers Association (“ABA”), and I am here today to testify on behalf of the ABA.

ABA, on behalf of the more than two million men and women who work in the nation’s banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

Thank you for the opportunity to present the ABA’s views regarding the ongoing efforts to implement the Basel II risk-based capital requirements in the United States. The ABA appreciates Congressional oversight of the regulators’ actions in this important area. Recent proposals by the regulators, while well-intended, have the potential to reduce the availability of affordable credit, adversely affect competition among banks, discourage progressive risk management practices, and add to the already heavy costs of compliance.

The 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’ (“Agencies”) recently promulgated Notice of Proposed Rulemaking (“Proposal”) fall short of that mark. In my testimony concerning the capital rules I would like to make the following points:

- 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.

- 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.

- 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.

The above 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 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 Basel II banks could bring the aggregate decline of all Basel II banks above 10 percent. Under such circumstances, it would not be appropriate to penalize all Basel II banks.

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 bank's 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.

It is also important to note that competition and capital flows do not stop at national borders. Therefore, 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 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, however, that could leave much of the rest of the banking industry subject to admittedly out-of-date capital standards and subject 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, and 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.

We congratulate the Agencies on their announced commitment to develop a revised version of the existing capital standards, sometimes called a Basel I-A standard. We compliment the Agencies on their plan to expedite the schedule for proposing alternatives to the Basel II capital rules so that they can be reviewed contemporaneously with the review of the current Proposal. 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 these standards 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 will also 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 detailed 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:

- 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 American 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 and could 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 support work to provide this option.

The Agencies also should continue their efforts to develop a "Basel I-A" approach that provides a meaningful option to the Standardized Approach. The current Basel I-A 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 I-A 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 I-A 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 I-A 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, given that no proposed rule has been published, it is impossible to offer views on particular changes to an existing regulation. If a Basel I-A 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, would not be an efficient use of resources. Hence, the existing Basel I rule is 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. However, 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.

CONCLUSION

The initiative to improve existing capital rules could impose burdens that far outweigh its benefits. Alternatives exist that would strike a better balance between costs and benefits than does the Proposal. We appreciate the Agencies' willingness to consider alternatives, and we remain committed to working with the Agencies toward the goal of keeping the banking industry a safe, sound, and vibrant provider of financial services.