WORLD SAVINGS



April 29, 2004

The Honorable Roger Ferguson
Vice Chairman, Board of Governors
Federal Reserve
20th Street and Constitution Avenue, NW
Washington, DC 20551

Roger
Dear Vice ~~Chairman Ferguson~~:

As I explained in earlier letters, I have major objections to the proposed new bank capital rules, commonly referred to as Basel II. Attached is a new letter I am circulating, with additional arguments against the Basel II approach. Let me know if you'd like to discuss any of the comments.

Very truly yours,

Herb

Herbert M. Sandler
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Enclosure

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Inertia and the Federal Reserve Board keep propelling U.S. adoption of Basel II along, even though: (a) other U.S. bank regulators have either expressed concerns about the accord or offered only tepid support, (b) many U.S. banking institutions and trade groups have significant concerns with the accord, including its competitive impact, and (c) Congressional leaders in the Senate Banking Committee and House Financial Services Committee have expressed reservations about the need for, and impact of, Basel II.

Even the Federal Reserve has yet to reconcile its views about appropriate capital levels in the U.S. For example, in recent testimony before the Senate Banking Committee, Federal Reserve Board Chairman Greenspan expressed considerable concern about the growing debt levels at Fannie Mae and Freddie Mac and their use of derivatives (rather than increased capital) to manage the risk of holding massive mortgage portfolios. Chairman Greenspan questioned whether these GSEs currently have adequate capital for their mortgage assets, and he advocated that any new regulator should have authority to increase both minimum and risk-based capital requirements for the GSEs. Ironically, at the same time that Chairman Greenspan is reaffirming the importance of maintaining sufficient capital for mortgage assets, Vice Chairman Ferguson is spearheading the Basel II accord that could dramatically reduce the capital that large U.S. banks would have to hold for mortgage assets to levels at or below the capital requirements of even the GSEs. It is startling to have such inconsistent messages about appropriate capital levels from the leaders of the U.S. regulator that is most actively promoting Basel II.

Another anomaly is that Chairman Greenspan wants a mortgage asset held by GSEs to require higher capital, while Vice Chairman Ferguson is recommending that the same mortgage asset held by a U.S. bank should need lower capital – unless, of course, the U.S. bank is a small- to medium-sized bank, in which case, a capital level well in excess of the proposed Basel II requirement would apply. It strains reason that the very same mortgage asset (with the same credit, interest rate, prepayment and other risks) should have such disparate capital treatment based solely on who is holding the asset. Disparate capital treatment seems not only illogical, it would profoundly disrupt and destabilize the nation's mortgage market, one of the most important segments in the nation's economy.

This is just one reason why Basel II is a misguided approach to capital regulation (for other reasons, see the attached). Basel I, possibly with modifications in the few areas where it may need updating, is a far more responsible approach because it provides a fair and level playing field for all U.S. banks, maximizes safety and soundness by ensuring that sufficient capital is available as a cushion against mistakes or unanticipated crises, and is transparent enough to be understood by directors, management, regulators and other market participants. Regardless of the risk-based capital accord that is in place, the U.S. leverage ratio requirements described under existing prompt corrective action legislation and implementing regulations must remain intact. Among other things, a minimum leverage ratio ensures that, regardless of the risk-based model used by a bank, there is at least a base level of protection in the event of a crisis, rather than relying primarily on an insurance fund or taxpayer bailout.

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## A Few of the Many Problems with Basel II

*Congress requires U.S. regulators to establish minimum capital requirements to ensure that the nation's banking institutions operate in a safe and sound manner. Under the proposed Basel II regime, the nation's largest banking institutions would, for the first time, be able to determine their own capital requirements from models the banks themselves create and manage. Below are just a few of the many problems with Basel II.*

1. **Complex rules that nobody understands**. It is never a good idea to adopt complex models that few in Congress, in regulatory agencies or in corporate board rooms can possibly understand. History has proven, time and again, that complex models often fail, either because the models do not account for real-world risks or because malfeasance is detected too late (Long-Term Capital Management, Enron, etc.).
2. **Mistakes would be disastrous**. What is at stake is the very stability of banking institutions that are critical to national and international financial systems. Given the interdependence of financial markets and the speed with which down-spirals can occur, the consequences of a mistake, even at just one Basel II bank, could be devastating.
3. **Insufficient focus on safety and soundness**. Capital accords exist, or should exist, principally to ensure sufficient capital is available as a cushion against mistakes or unanticipated crises. Basel II deliberations have focused almost exclusively on complex risk-based capital formulas, and there has been far too little discussion about whether the new regime would maintain, much less improve, safety and soundness.
4. **Corporate governance concerns**. It is more than a little ironic that, in this period of heightened concern about corporate governance and effective oversight, few directors or executive officers at Basel II banks would have anywhere close to an adequate understanding of Basel II or the bank's own risk-based model.
5. **Concerns about who will be running the models.** Capital at the nation's largest banks would be determined by a handful of technicians and/or outside consultants who are unlikely to appreciate all the dynamics and development that could dramatically impact real-world risk at the bank, and whose reputations and compensation may well depend on justifying minimum capital levels.
6. **Deterioration of the models over time.** Even if a bank's model works on day one, it will require continual adjustments as circumstances at the bank and throughout the industry change. Personnel turnover at the bank and at its regulator will inevitably occur, and their successors will not understand all the tradeoffs, assumptions and other idiosyncrasies built into a given bank's model. Later generations will be less equipped to recognize problems in the model or to acknowledge its obsolescence.
7. **Incentives to drive capital levels down.** A bank can improve its ROE by lowering capital (and management can often improve their compensation by increasing ROE). In the face of domestic and international competition, a Basel II bank would have every incentive to use its model to reduce capital levels as low as possible.
8. **Moral hazard**. The nation's largest banks who would adopt Basel II would all race toward the lowest amount of capital reserves, thereby distorting the purpose of a capital regime. These happen to be the very same banks deemed "too big to fail" and that the government would be expected to bail out.
9. **An uneven playing field**. The amount of capital that a bank holds behind an asset should be determined by the risks associated with that asset (credit, prepayment, interest rate risk, etc.), not by whether the bank holding the asset is one of the nation's ten largest. A bifurcated capital scheme would disrupt settled markets and give the nation's largest banks a competitive advantage over other domestic banks.
10. **Supervisory challenges**. The regulators themselves, especially those in the field, have expressed concerns about whether they will have the resources and technical skills necessary to supervise the implementation and maintenance of the banks' models. Basel II does nothing to improve supervisory standards, and without effective regulatory oversight, the prospects of a systemic breakdown become more certain. It is difficult to imagine a regulator will ever be able to respond quickly enough when things start to go wrong.

For more detailed views on these and other points, please refer to http://www.fdic.gov/regulations/laws/federal/03cworldsavings.html