Testimony on Basel II Capital Accord
by
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before the
Subcommittee on Financial Institutions and Consumer Credit
of the
House Financial Services Committee

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I. Introduction

Good morning, Chairman Bachus, Congressman Sanders, and members of the Subcommittee. Thank you for the opportunity to discuss the proposed revisions to the 1988 Capital Accord (Basel I) developed by the Basel Committee on Banking Supervision (BSC). Although the Office of Thrift Supervision (OTS) has been involved in the Basel process for some time, we have only recently attempted to engage ourselves in the process internationally. While we are very supportive of the Basel process, there are numerous policy implications involved in the recently proposed international capital standards for banking organizations in the United States. These include issues that we all must strive to understand and address. I welcome your efforts to highlight these pending and important changes.

The proposed change in capital standards currently under consideration arises from a third Consultative Paper, CP-3, recently issued for public comment by the BSC. CP-3 is expected to result in the New Basel Capital Accord, or Basel II. Basel II will directly affect the largest and most internationally active banking organizations around the world, including approximately ten banking organizations in the United States. Basel II may also significantly impact, albeit indirectly, all other banking organizations around the world, including roughly 9500 institutions in the United States. These institutions include large, medium, and small banks and thrifts that operate nationally, regionally, and at the community level, many of which compete domestically with our largest internationally active banking organizations.

Before getting into the substance of my discussion on Basel II, there is one point relevant to the ongoing Basel process that I believe is important. While we have been very involved domestically in the Basel process for a number of years, as I mention above, OTS is currently attempting to take a more active role internationally because of the impact of Basel on the institutions we regulate. In this regard, I would urge the Chairman and members of the Subcommittee to include

OTS within the context of any legislation, such as H.R. 2043, that would establish an interagency committee within the United States to oversee Basel issues. If a United States Financial Policy Committee is established, it is extremely important that OTS, the primary federal regulator of all savings associations, be included.

II. Development of Basel II

Basel I, signed in 1988, addressed only the largest, internationally active banks in G-10 countries and encouraged countries outside the G-10 to adopt the framework for their banks that were operating internationally. The underlying principles of Basel I, however, were intended to apply to all banking organizations of any size and activity. Thus, while OTS did not sign Basel I, we applied it along with the other federal banking agencies. Since Basel I, the four banking agencies have developed risk-based capital standards consistent with its underlying principles, but with modifications intended to enhance risk sensitivity.

In connection with our involvement and experience with Basel I, OTS has been monitoring for many years the work leading up to Basel II. Because of the potential impact of Basel II on the institutions we regulate, we recently stepped up our involvement in the Basel process. In anticipation of the domestic application of Basel II, OTS is participating fully in preparation of an interagency Advanced Notice of Proposed Rulemaking (ANPR), with accompanying supervisory guidance, to be published in the Federal Register in the near future. The initiative will trigger the official kick-off of the national debate on the subject of new international capital standards, but, as you are aware, many of the issues raised by Basel II have already attracted significant attention. While OTS has not been directly involved in the international deliberations to date, our role on the domestic front—particularly in the mortgage markets—provides us a unique and useful perspective for this discussion.

In Basel I, the BSC identified two fundamental objectives at the heart of its work on regulatory convergence. As the Committee stated, first, "the new framework should serve to strengthen the soundness and stability of the international banking system; and [second,] the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks." Although the BSC developed a far more detailed and risk-sensitive capital adequacy framework in Basel II than in the original accord, it does not stray from the objectives set 15 years earlier. In fact, the BSC expanded upon these objectives as a guide to its efforts in producing the current proposal. In particular, the Committee observed that Basel II should:

- Continue to promote safety and soundness and at least maintain the current overall level of capital in the system;
- Continue to enhance competitive equality;
- Establish a more comprehensive approach to address risk;
- Contain approaches to capital adequacy that are appropriately sensitive to risk; and
- Focus on internationally active banks, although its underlying principles should be suitable for application to all banking organizations.

While the objectives for Basel II set forth by the BSC are important to ensure consistency and competitiveness among internationally active banking organizations, the impact of the proposed changes may affect many other banking entities domestically. It is important to encourage a thorough discussion among the regulators, Congress, and the thousands of banking organizations in the United States that may be affected, directly or indirectly, by Basel II. Hearings such as this and the upcoming ANPR will help stimulate this debate.

III. Overview of Basel II

Basel II contains three "pillars" that are intended to be mutually reinforcing. Pillar 1 is a minimum regulatory capital requirement; Pillar 2 addresses supervisory review; and Pillar 3 is intended to promote risk and capital transparency. Briefly, a description of these is as follows:

- Pillar 1 includes a credit risk component that is measured by either a standardized approach or one of two internal ratings-based approaches. The two ratings-based approaches or models are the Advanced Internal Ratings-Based (AIRB) approach and the "Foundation" approach. Pillar 1 also includes an operational risk component that has several optional approaches. The centerpiece of the operational risk component of Pillar 1 also permits use of an internal model, the Advanced Measurement Approach (AMA).

- Pillar 2 is viewed by the BSC as a way for the banking supervisors to attain better overall risk management and internal controls at the banking organizations we regulate.

- Pillar 3 includes a wide range of disclosure initiatives designed to make the risk and capital positions of banking organizations more transparent.

IV. Issues for Consideration

As I noted at the outset, OTS has only recently sought to be involved internationally in the Basel process. While we are supportive of this process and encouraged by the work completed so far, both domestically and internationally, there are a number of issues that we have considered regarding the application of Basel II in the United States. In the following discussion, I highlight some of these issues.

A. Competitive Equality

Regardless of how we strive to explain Basel II, the extraordinary technical detail at its core is substantial. Our banking organizations will need to master the complexity of Basel II to provide effective feedback during the upcoming ANPR comment process on the balance of its burdens and benefits. As we proceed, we need their input to weigh changes to our existing capital rules, and to assure ourselves that our actions do not significantly alter the competitive landscape for all U.S. banking entities. We want to assure that United States banking organizations remain healthy, competitive, and well capitalized.

The key principle underlying Basel II, and the basis for the advancement from Basel I, is greater risk sensitivity. This principle has as much meaning for a small community banking organization as it does for a large internationally active institution. The challenge lies in how to address this issue simultaneously for both types of banking organizations, especially considering that under the proposed scope of application in the United States all but the few largest banking organizations will not be "Basel II banks." A significant issue in this debate is whether we maintain consistent capital standards for all banking organizations for lending activities that have the same risk characteristics.

From our standpoint, maintaining competitive equality for community banks is important, particularly as our economy is showing encouraging signs of improvement. Community banking organizations play a significant role in small business lending, which feeds new job creation. "Community banks are one of the key sources of credit and other financial services to small businesses—the most prolific job creating sector of our economy. Small businesses employ 60 percent of the nation's workforce and have created two-thirds of all the net new jobs since 1970."[1]

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[1] Statement of Paul G. Merski, Chief Economist and Director of Federal Tax Policy, Independent Community Bankers of America, before the House Small Business Committee, March 1, 2002.

Another aspect of this issue that we must consider is the extent to which we alter our existing capital rules, applicable to all banks, to accommodate changes proposed by Basel II. For example, under Basel I, the blunt-edged risk-based capital requirement for 1-4 family residential mortgages (a 50 percent risk-weight, or 4 percent capital requirement) is not commensurate with the historical risk associated with residential mortgage lending in the United States. For residential mortgage loans with relatively low loan-to-value ratios, a substantially lower risk-weight is more reflective of loss experience. By contrast, the federal banking agencies have concluded that for some concentrations of subprime loans, a significantly higher risk weight than 100 percent—and therefore, a capital requirement higher than 8 percent—might be more appropriate. While Basel II is intended to enhance the risk sensitivity of our capital rules, it is important that the proposed changes are truly reflective of actual risk, as measured over an appropriate historical timeframe.

B. Supervisory Effectiveness

Another important issue is the potential impact of Basel II on our supervisory effectiveness. The United States bank regulatory system is considered to be among the most comprehensive and admired in the world. Capital requirements are only part of our multi-faceted supervisory response to ensure safety and soundness. Our supervisory system is grounded in a regular program of on-site examinations complemented by comprehensive and frequent reporting and off-site monitoring—a level of supervisory review that may be unparalleled.

As we move forward with a relatively dramatic approach that places a tremendous emphasis on capital, we must be careful not to minimize or diminish the other supervisory tools and regulatory judgment that is integral to our supervisory system. In particular, we should focus on how Basel II fits within and improves our system, and how to strike the right balance between capital rules and effective supervisory oversight. In the end, sound regulatory judgment is the key to our supervisory effectiveness and cannot be compromised.

C. Accountability in a Ratings-Based Capital Model

A corollary to this issue is the role of examiners and our examination process in evaluating ratings-based models dictated in a Basel II supervisory world. The application of Basel II in the United States will include complex mathematical formulas and models used to measure regulatory capital levels for our largest financial institutions. While prior regulatory approval is required to use the models, once obtained, an institution would effectively set its own capital requirements. This would be based largely on inputs derived from credit assessments from the institution's own credit risk and operational risk models.

The accuracy and consistency of ratings is extremely important in any ratings-based system. Numerous subjective decisions are made daily by bank personnel regarding model inputs. These inputs involve judgments made on items such as rating a loan's probability of default, an estimate of loss given default, and the probability of a major loss arising from an institution's operational risk. It is important to keep in mind that these are human inputs, and are not infallible. Of particular concern is how to account for the subjectivity of the "human factor" as we implement and apply Basel II.

Equally important is that we take the steps necessary to support and train our examiners who will be expected to review the many subjective decisions made under, and evaluate the mathematical models of, Basel II. We must also consider how the Basel II models and mathematical formulas reconcile with our existing rules, such as with our asset risk classification and prompt corrective action rules. This includes whether any of our existing rules, in addition to risk-based capital, would have to be changed to accommodate Basel II.

D. Operational Risk

Another important issue is the operational risk capital charge in Basel II. The concerns include the difficulty of trying to measure something that cannot be readily modeled. Currently, the ability to measure and quantify operational risk is less advanced than the measurement and quantification of credit risk. In addition, the boundaries between credit risk and operational risk are not always clear. Another question is whether operational risk should receive a more qualitative Pillar 2 supervisory review as opposed to the quantitative Pillar 1 approach proposed in Basel II. This question is significant because assessment of operational risk inherently involves human judgment, which lies more squarely within Pillar 2.

There are also questions about the availability of good data to measure operational risk. Under the AMA model of Pillar 1, the most sophisticated institutions would use available external data to measure risk and compute their own capital charge. While data may be readily available for ordinary risk events that can be budgeted, truly high-risk loss events occur infrequently. We must consider how to proceed where there is a lack of readily available data for precisely the type of risk for which capital may be most relevant to a particular institution or group of institutions.

We will also want to consider the positive effect that an institution's internal systems and controls have on operational risk exposure. In computing their operational risk capital charge, it is important to understand whether and how different institutions would allocate capital appropriately for weaknesses in their internal systems and controls, as well as the disincentives in doing so. This is important to ensure both consistency and accuracy in the operational risk capital charge.

V. **Conclusion**

Thank you, Chairman Bachus, Congressman Sanders, and members of the Subcommittee for the opportunity to testify on Basel II. As you are aware, Basel II raises very significant issues not only for our very largest banking organizations, but potentially for all our insured institutions. I urge all of the members of the Subcommittee to remain involved in this process going forward. In addition, I reiterate my request that OTS be included on any committee formed by Congress to oversee Basel issues in the United States.