Statement of

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on

The Impact of the Proposed Rules to Implement Basel III Capital Standards

Before the

Subcommittee on Financial Institutions and Consumer Credit

and the

Subcommittee on Insurance, Housing and Community Opportunity

of the

Committee on Financial Services

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Good morning, Chairman Capito, Chairman Biggert, and Members of the subcommittees on Financial Institutions and Consumer Credit and Insurance, Housing and Community Opportunity. My name is Jim Garnett, and I am the Head of Risk Architecture for Citi. In this capacity, I am responsible for implementing the Basel III capital rules for Citi within the United States and the other countries in which Citi operates around the globe. I want to thank you for holding a joint hearing on this very important topic.

Background

Citi today is among the best capitalized major banking institutions in the world, and we support strong capital requirements as one of the critical pillars of a safe, sound, and effective financial system. We have added over $140 billion in new capital to our capital base. Our capital strength is more than five times higher than it was during the crisis, and although the Basel III capital requirements do not fully kick in until January of 2019, Citi is well underway towards complying with them, both the baselines and surcharges. We are in a position to put our financial strength to work for our clients during challenging and uncertain economic times, and we are doing so.

In addition to increasing our capital, we have gone back to the basics of banking and have streamlined our company to focus on our core areas of strength – consumer banking and institutional banking including transaction services – with a clear structure and a clear strategy. Since 2009, we have invested in core businesses while reducing non-core assets. After completing more than 60 divestitures, we have reduced Citi Holdings by $600 billion and it now represents less than 10 percent of Citi's balance sheet. Our risk management has been completely overhauled and is a strong, independent function. Since the financial crisis, we have put in place a robust governance structure. We have significantly increased our liquidity resources; cash and available-for-sale securities represent 25 percent of the balance sheet; and our available liquidity resources – cash and highly liquid securities – are in excess of $400 billion. By successfully executing our strategy, we have achieved sustainable earnings with 11 straight quarters of profitability. In short, we are now a simpler, smaller, safer, and stronger institution than we were a few years ago.

The Impact of Capital Rules Proposed by U.S. Banking Regulators

Citi broadly supports the goals of the Basel III capital rules proposed by the U.S. banking regulators. As a global bank, Citi has long supported risk-based capital standards along with heightened liquidity standards. We recognize the importance of capital to serve as a buffer against changing market and economic conditions. Aligning capital with economic risks ensures that adequate capital exists to cover risks and avoids excess capital, which can unnecessarily constrain lending and investment activities that support the real economy.

There are, however, certain features of the proposed rules that deserve refinement in order to avoid unintended, negative consequences. We are concerned that the cumulative capital levels will unnecessarily constrict credit for all but the nation's most credit-worthy borrowers. Additionally, we believe the elimination of the filter for accumulated other comprehensive income (AOCI) in calculating Tier 1 Common Equity will negatively impact the ability of banking organizations to extend new credit and cause banks to reduce investments in certain U.S. Treasury and agency debentures and mortgage-backed securities (MBS).

We are also concerned about the apparent lack of uniform application of capital and other supervisory standards within the U.S. and globally. U.S. and international banking regulators need to ensure that the Basel III rules are applied consistently and uniformly. Deviations in risk weighing should not be allowed.

Finally, we believe that capital rules should be tailored to different types and sizes of banks. We support a simpler set of risk-based rules for small, traditional community banks.

I will address each of these issues in the balance of my remarks.

Credit Availability

The financial crisis demonstrated a need for banks and other financial institutions to hold greater levels of capital. We support strong capital requirements and, as noted above, we have dramatically increased our capital since the crisis. At the same time, there is clearly a trade-off between higher capital and credit availability and cost. The obvious challenge is to find the right balance between capital levels necessary to withstand periods of economic stress and capital levels that do not choke off credit availability and investment.

We are concerned that under Basel III, consumers who do not have pristine credit histories will find credit to be less available and more expensive. This result will be particularly evident for consumers with weaker credit histories seeking residential mortgage loans or home equity lines of credit. Small business owners also will be adversely affected in the form of higher credit costs and constrained credit availability, particularly because small businesses do not have direct access to the capital markets - *i.e.,* they cannot borrow by issuing commercial paper or longer term notes and bonds, in contrast to the largest corporations who have the capital markets as an alternative source of credit. Basel III penalizes those who need credit the most across all institutions.

To help avoid capital standards that divide consumers between the “haves” and the “have nots,” we support the industry’s call for a quantitative impact study of the proposed rules. Such a study would enable Congress, the federal banking regulators, and others to better understand the impact of the proposed rules and, if appropriate, to make adjustments that avoid an unintended contraction in credit to many customers.

AOCI Filter for Gains and Losses on Securities Available for Sale

In a major change from the current capital rules, the proposed rules would require unrealized gains and losses on securities that are held as "available for sale" by a bank to flow through to a bank's regulatory capital levels. Current capital rules impose a "filter" that prevents fluctuations in the value of such securities from passing through to regulatory capital. We believe that the elimination of this filter is ill-advised. The elimination of the filter will create inaccurate reports of actual capital strength; it will mean that capital will look like it is increasing as interest rates fall and decreasing as interest rates rise – but neither result will reflect reality.

Since fluctuations in interest rates impact the value of the securities held for sale, Citi and other U.S. banking organizations will be required to hold capital buffers to account for the potential swings in capital levels. This will exacerbate the aforementioned impacts of holding excessive capital in the banking system.

The removal of the filter also will cause Citi and other U.S. banking organizations to favor shorter duration securities over longer-dated Treasuries and MBS, because the value of shorter duration securities is less subject to swings in interest rates. This will inevitably impact the issuance and cost of Treasury securities and housing credit.

The removal of this filter will reduce a bank's flexibility in managing liquidity and diminish liquidity in the underlying debt markets. Additionally, the removal of the buffer provides a disincentive for prudent asset and liability management activities as banks will need to weigh the tradeoff between managing the risk of AOCI volatility and economic risk.

Finally, the removal of this filter will create an unlevel playing field between U.S. and foreign banks, since foreign banking organizations that follow international accounting standards are permitted to defer gains and losses by accounting for certain debt securities as loans.

We understand the rationale behind this proposed change given the credit related losses incurred during the recent crisis that were not reflected in capital. However, a better solution would be to continue to exclude unrealized gains and losses in Basel III Tier 1 Common Capital for available for sale securities of only the most creditworthy and liquid issuers. In other words, the filter should remain in effect for obligations issued or guaranteed by the U.S. government or government agencies. This approach would create consistency between the regulatory capital treatment of securities and the regulatory capital treatment of the deposit liabilities they are largely hedging, and it would reduce the negative consequences caused by volatility in regulatory capital levels.

Global Harmonization

One of the fundamental goals of the Basel Capital Accords is the harmonization of capital standards among industrialized countries. Having uniform and consistently applied capital standards ensures market confidence in banking organizations and promotes safety and soundness. Recently, however, regulators and investors have raised concerns about differences in risk-weighting systems used by banks in some countries. Asset risk-weights are a central feature of the Basel capital standards; they can determine how much – or how little – capital a bank needs to hold against a particular asset. It is imperative that U.S. and international banking regulators ensure that the Basel rules are applied uniformly and consistently by all banks. Otherwise, the integrity of the international capital standards will be compromised.

An unlevel Basel playing field across national jurisdictions can arise from two different sources. First, banking supervisors in different countries may apply different standards when approving internal models or internally calculated risk parameters. There is a great deal of concern that supervisors in some countries, like the U.S., will adhere to high standards of approval while those in other countries will adhere to laxer standards. An excellent method for determining if different supervisory standards are used is to require each bank to calculate the risk-weighted assets (RWA) of benchmark portfolios using the bank's current methods and assumptions. In fact, the Basel Committee's Standards Implementation Group has begun working on the use of benchmark portfolios to this end, as have some national regulators.

A second reason for an unlevel playing field could be that even if the Basel rules are adopted and implemented uniformly, a given rule can have a disparate impact across national jurisdictions because of differences in market structure and associated accounting standards across countries. For example, Mortgage Servicing Rights (MSRs) are a large asset for many U.S. financial institutions, from small community banks to larger multinational banks. Basel III initially excluded all MSRs from inclusion in Tier 1 Common. The final version of Basel III limited MSRs to only 10 percent of Tier 1 Common. MSRs are essentially only a U.S. bank issue. They arise from the combination of residential mortgage securitization and the details of generally accepted accounting principles (GAAP). Consequently, the limitation on the recognition of MSRs essentially only affects U.S. banks.

Community Banks

We believe there is a good case for applying a more simplified risk-based capital regime than the Basel III rules for small community banks. While the Basel I regime is overly simplistic for large banks, it can be an effective capital regime for smaller, community banks that do not have complex balance sheets. These types of traditional community banks primarily make commercial real estate and residential real estate loans, automobile and other consumer loans, and business loans. They also have investment portfolios that are largely composed of Treasury securities and MBS. They do not need the highly granular risk categories proposed in Basel III.

Basel III also poses greater operational and compliance challenges for community banks than for large banks. Basel III is a comprehensive rewrite of the capital rules, and compliance with these rules carries significant costs. Large banks, like Citi, already have incurred many of these costs in preparation for Basel II. Large banks also enjoy economies of scale in technology and systems. Community banks are justifiably concerned about the compliance costs imposed by Basel III. The federal banking regulators should reconsider the application of Basel III to traditional community banks that do not have complex balance sheets and permit such institutions to continue to comply with Basel I or some other simplified risk-based capital regime.

Conclusion

Thank you again for the opportunity to appear before the subcommittees to discuss some refinements to the Basel III rules that we believe are needed to avoid unintended, negative consequences.