

Statement Of
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Committee on Banking, Housing and Urban Affairs
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Chairman Shelby, Senator Sarbanes, and members of the Committee, I appreciate this opportunity to discuss plans of the U.S. banking agencies to strengthen regulatory capital requirements for our banking system.

We intend to do this in two fundamental ways: first, through implementation for our largest banks of the Framework generally known as Basel II; and second, for banks not adopting Basel II, through revisions to our capital rules in an initiative generally known as Basel IA.

In both efforts, our primary goal is to substantially strengthen the long-term safety and soundness of our banking system. Our largest banks require a more risk sensitive regulatory capital system to address their complex operations and activities. For banks not adopting Basel II, we need to increase the risk sensitivity of risk-based capital without unduly increasing regulatory burden.

To ensure that Basel II would be consistent with continued safety and soundness, the U.S. agencies conducted a quantitative impact study earlier this year known as QIS-4. As you will hear in more detail today, the QIS-4 results – which were based on crude approximations of Basel II requirements – nevertheless raised real concerns among the agencies because it forecast substantial reductions in capital for Basel II banks, and substantial differences in capital requirements for very similar credits. Because these preliminary results would be unacceptable if produced by the final Basel II Framework, the agencies conducted in-depth discussions about QIS-4 and what they should mean for the future of the Basel II process. The result of these discussions was an agreement by all the agencies to move forward, but only with substantial new safeguards to address the QIS-4 concerns. This agreement, which was released as a joint statement on September 30, was based on several key premises:

- First and foremost, despite the preliminary forecasts of QIS-4, the Basel II Framework provides necessary improvements to address recognized flaws in the existing risk-based capital regime for our largest, most complex banks. Basel II will promote significant advances in risk management that will benefit supervisors and banks alike and substantially enhance safety and soundness.
- Second, apart from the notice and comment process, further study of the Basel II Framework itself will do little to resolve concerns raised by QIS-4, which by necessity was based only on preliminary approximations of a completed Basel II system. Instead,

we need to observe live systems in operation – and subject them to rigorous supervisory scrutiny – before we will be able to rely on Basel II for regulatory capital purposes.

- Third, we must proceed deliberately, gaining a better understanding of the effects of Basel II on bank risk management practices and capital levels. That means a meaningful transition period during which we can scrutinize Basel II systems while strictly limiting potential reductions in capital requirements through a system of simple and conservative capital floors. Based on the experience we gain through supervisory oversight in the transition period, we will incorporate any necessary revisions to Basel II before the transition period ends.

I believe that, once the Basel II framework is implemented completely and rigorously supervised in the controlled environment of the transition period, and once we have had the opportunity to make necessary changes to the framework based on the knowledge we gain during that period, the concerns raised by QIS-4 will be addressed.

While the comprehensive Basel II framework is necessary and appropriate to address the complex risks of our largest banks, it would be far too burdensome and expensive to impose on our other banks. Instead, we need meaningful but simpler improvements to our capital rules for these banks that would first, make capital more sensitive to risk, and second, address competitive disparities raised by the Basel II changes for our largest banks. That is the purpose of our Basel IA initiative, in which the modifications we are considering would increase the number of risk-weight categories; expand the use of external credit ratings; and employ other techniques to increase the risk sensitivity of capital requirements.

The banking agencies agreed that it is critical to have overlapping comment periods next year for the rulemakings on both Basel II and Basel IA. This will allow the industry to compare the proposals as they prepare their comments, and will allow the regulators to take both sets of comments into account in finalizing each proposal – a process that will allow a better assessment of the potential competitive effects of these proposals on the U.S. financial services industry.

To summarize, doing nothing to revise our capital rules would, over time, threaten the safety and soundness of the banking system, especially with regard to our largest banks that engage in increasingly complex transactions and hold increasingly complex assets. Basel II provides a conceptually sound and prudent way forward for these largest banks by more closely aligning regulatory capital and risk management systems with actual risk. Likewise, Basel IA will provide a more risk sensitive framework for non-Basel II institutions. Although both processes will take time and will inevitably change to address supervisory concerns, I believe they both will substantially enhance safety and soundness.

It is for this essential reason – safety and soundness – that I believe we should support the approach embodied in proposals for Basel II and Basel IA.

Thank you very much.