THE FINANCIAL SERVICES ROUNDTABLE

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Basel Committee on Banking Supervision
Bank for International Settlements (BIS)
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Dear Sir:

The Financial Services Roundtable ("Roundtable") is a national association representing 100 of the largest integrated financial services companies in the U.S. providing banking, insurance, securities, and investment products and services to American consumers. Our Members have been heavily involved in the BIS Committee process regarding Basel II and we have recently testified before the U.S. Congress on the topic. We appreciate the willingness of the BIS Committee to consider our views.

Introduction

The Basel II Capital proposals have been the topic of intense discussion and debate in the financial and regulatory community for the past several years. The industry supports the objectives of the Basel process: to better align regulatory capital to underlying economic risks, promote better risk management and foster international consistency in regulatory standards. The proposed Accord is not a minor refinement to the bank regulatory process, but is, instead, a wholesale reform of bank regulation – a regime that affects roughly $2 trillion of capital and is a key economic engine for all developed markets. The impacts of these seemingly technical discussions will affect banks, the markets and the economy in a deep way, and we would be wise to consider the effects carefully before implementation.

Initially, we would like to note our tremendous respect for the diligence and stamina of the regulators who have worked on Basel II. You have had to address a great many complex and challenging issues, and you have been tenacious in trying to develop a "best practice" solution for each. Balancing all of this and applying it to very different financial markets around the world – with political sensitivities in each – does not make this an easy job. We also wish to express appreciation for the efforts of Federal Reserve Board Vice Chairman Roger Ferguson, who has met with Roundtable member companies several times in the past few weeks to listen to our concerns on the proposed Accord. Comptroller Hawke and FDIC Chairman Powell have also had open doors for discussion throughout the long process of developing the new Accord. We look forward to continuing this dialogue as Basel II moves closer toward formal adoption and throughout the implementation period.

The Roundtable and its members have worked hard to be constructive commentators on the new rules, particularly with respect to practical implementation issues. The recent revision of the proposals – called CP3 – included significant improvements, and demonstrated a willingness by regulators to address specific issues raised by industry and academic commentors. For example, recently, the U.S. regulators have announced that, in implementing Basel II in the U.S., they propose to reduce the capital charges on many types of commercial real estate loans in response to comments and new data from the banking industry. We support the direction in which the Accord has been moving recently, and appreciate the regulators' willingness to reexamine their earlier statements and consider further changes.

However, we believe that there still are substantial areas for improvement that remain. Basel II has considerable momentum, and most people in the industry believe it will be implemented in the relatively near future. On balance, we believe that the advantages of the reform marginally outweigh the drawbacks. In several areas, open issues remain. This is a not a satisfactory state for an initiative that has so much potential. We hope that we can help further clarify some of the important remaining issues that need to be addressed, for the Basel II reforms to live up to their very worthy goals.

Without getting too involved in the technical details of the Accord, we would like to highlight four "macro" issues which we believe are particularly important:

1. The current Basel proposal is unnecessarily complex and costly to implement, and suffers from an excessive reliance on detailed, prescriptive rules. Under the rubric of comparability, these international rules could bring a more formulaic, inflexible style of regulation to the U.S., which currently enjoys a reasonable balance between black-letter rules and supervisory consultations.

2. The new Accord's sensitivity to credit ratings could reduce liquidity in the credit markets during economic downturns, potentially extending or deepening economic recessions ("pro-cyclicality").

3. The operational risk capital charge proposed by the Basel Committee remains highly controversial. Some Roundtable members support the proposed Pillar I operational risk charge; others believe operational risk should be addressed through Pillar II supervisory reviews instead.

4. The disclosures required under Pillar III of the new Accord are likely to add perhaps 20 pages of highly technical data to bank reporting requirements, raising costs and adding information of little value to the reader. While we appreciate that the Pillar III disclosure requirements have been reduced, they continue to be burdensome and confusing.

Prescriptiveness, Cost, and Adaptability

The first topic we would like to address is the overall cost and prescriptive tone of the new capital rules, and the impact this will have on whether the rules remain effective over time. The new rules shift the regulatory emphasis toward a highly complex, formula-based system, and will diminish the important role that is currently played by human judgment. Implementation of these rules will be costly, but not cost effective. Moreover, we believe the very complexity of the new rules and the delicate political balance represented in them will make it difficult to deal with updates to the rules over time.

Most of this prescriptiveness is to be found in Pillar I, which describes the "recipe" for calculating capital requirements. The most recent draft of the Pillar I calculations ran to nearly 200 pages, roughly 5 times the length of the original Basel Accord (not including technical papers and additional guidance that is expected to be issued). This is a common situation resulting from this kind of process. Once you start developing a system that is meant to capture the complexity of the real world in a series of mathematical rules, it is very hard to stop halfway. One issue or another will always be of major concern for some institution or country. Many of the Pillar I rules reflect a political compromise as much as they do the results of a scientific approach to risk management. The result is a very elaborate system that tries to address all circumstances by being ever more complex. The Basel Committee has done a commendable job in streamlining the earlier drafts in CP3 – the earlier drafts of Pillar I rules were even longer – but size and complexity remains fundamental issues.

Perhaps the underlying issue in this respect is the prescriptive nature of the new Accord. Conceptually, the Committee has attempted to capture current industry best practices and boil them down into fixed formulae, adding burdensome qualification, testing, and reporting requirements.[1] These new regulatory requirements, while well-intentioned, will be unduly burdensome and inconsistent with changing market reality and evolving best practice.[2] We recommend that the Committee establish some relatively

[1] One editorial recently described this approach as "prescribing and proscribing in equal measure . . .a monster that can't clear the first hurdle: flexibility." *Risk Magazine*, editorial page, June 2003 edition.

[2] For example, the eligibility requirements for institutions to qualify to use the Accord's advanced IRB methods for credit risk capital charges are too detailed and burdensome. In general, we believe that these eligibility requirements should be scaled back and replaced with more general guidance.

A specific example is the testing requirements for credit exposure in repurchase agreements, an area with historically very low losses. To its credit, the Basel Committee permits the use of internal market risk models to estimate potential collateral shortfalls under stress, which is in line with modern practice. However, the Committee requires simple basic requirements, largely around the key input parameters and exposure calculations, and publish best practices that provide guidance to banks and supervisors rather than a rigid rulebook.

Roundtable members are also concerned about the cumulative effect of numerous conservative choices and assumptions that are built into this complex fabric. Each of these can be debated separately, and many are extremely technical. But the combined effect of each of these individual items adds up to regulatory capital requirements that can depart significantly from the true economic capital needs that Basel II was aiming to emulate.[3]

Home/Host Country Issues: The complexity of the new rules poses particular challenges for an international bank that is regulated by supervisors in a number of countries. International banks face a set of interlocking regulations in which both home and host countries interpret and enforce rules. This can give rise to conflicts, even under an international standard such as the Basel Accord. At times, some of our members have been given conflicting requirements by home and host regulators under Basel I. The potential tension between "home and host" regulators will become a bigger issue given the much wider and more detailed Basel II regime. If each country decides to require its own local rules and local data for each of the many calculations required under Basel II, the compliance burden will become even worse. The Basel Committee has formed an Accord Implementation Group to deal with cross-border implementation issues, but experience shows that some differences among numerous supervisors are inevitable.

We are pleased to note that, in a recent speech, Vice Chairman Ferguson indicated that the U.S. banking regulators expect to accept the Basel II approaches and calculations

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substantial additional testing to use this technique, even though this calculation is based on the same model that governs overall market risk, which is a much bigger risk and already subject to comprehensive regulatory oversight.

[3] To mention a few examples:

(i) The Accord significantly overstates the credit risk capital charges for exposures hedged by guarantees and credit derivatives, by failing to recognize the much lower risk of joint defaults by debtors and guarantors and by applying overly conservative rules on maturity mismatches.

(ii) The proposed Accord requires capital against Expected Losses, even though these losses are already covered by loan loss reserves, and Future Margin Income is generally recognized only for credit card exposures.

followed by a bank's home country supervisors when evaluating an international bank with U.S. branches and for purposes of eligibility of the Financial Services Modernization Act (also known as the Gramm-Leach-Bliley Act) financial holding company status. This is reassuring. We hope that other host countries adopt similar policies deferring to home country regulators, and that similar issues relating to subsidiary banks are similarly addressed. We believe that stronger proposals should be developed to resolve home/host country conflicts in a timely and more predictable manner.

Securitization: A germane example of Basel II's complexity and excessive prescriptiveness is its proposal for asset securitization. Asset securitizations are a cornerstone of how the U.S. markets finance residential mortgages, consumer credit card balances, automobile loans and other receivables. The draft Basel II rules here are daunting, potentially very burdensome, and often difficult to interpret. The result is that only a few experts in each area are likely to understand these and other specialized rules of the Accord. Yet, the interpretation of these experts on some technical points can have an enormous impact on the capital calculation.

These rules are written to deter possible arbitrages in the new rules, but risk "throwing the baby out with the bath water." The industry and regulatory communities generally agree on the objective that capital should be similar before and after securitization, since the total economic risk is unchanged. However, apportioning the risk properly among the different securities poses a difficult challenge for any set of static rules. The Basel Committee's current proposal under CP3 takes a conservative approach to this problem, focusing on avoiding improper capital arbitrage by building a technically complex system with an ultraconservative [Note: "Suspenders" has a different meaning in the UK] philosophy. Unfortunately, this approach will interfere with legitimate transactions and undermine a widely accepted risk management tool used by many U.S. institutions.

Several problems remain that should be reviewed by the regulators. First, the mere act of securitization and distribution will tend to increase the capital charge assigned to the same pool of assets.[4] This increased capital is a more important issue for the U.S. markets in particular, as compared to markets in other countries, which are much less reliant on securitization technology. The proposed approach will raise costs for funding U.S. consumer loans and other asset classes where securitization techniques are important. Regulators outside of the U.S. have much less at stake in their local markets.

Second, the calculations are difficult to interpret. This can give rise to "cliff edge" uncertainties, where capital charges can change by a factor of ten or more depending on whether a particular instrument can be assigned to a specific regulatory box. For example, a credit line provided to support a credit card or receivables facility might attract a risk weighting of 100% *if* the bank can satisfy a number of technical tests about the structure of the credit facility.[5] However, this charge can skyrocket to 1250% (i.e., an outright deduction from capital) if a bank cannot meet one of these compliance requirements. This is a conservative approach[6] that will certainly help to deter arbitrage, but it may also deter good finance. It also will tend to restrict the evolution of new markets and new securities, since such future instruments might not fit easily into today's compartments. As with other areas of the Accord, we believe that moving to a more principles-based system that leaves more discretion to banks – subject to thorough supervisory oversight – will provide a more durable and flexible solution for the long term. It is important to incorporate these changes into both the final text and in the practical implementation of the rules.[7]

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4 For example, the originating bank is charged the full risk of the pool if it retains a sufficiently large position in the junior securities. A second bank that purchases the senior securities also will be charged significant capital, meaning that the capital required of the banking system will be higher than if the assets had simply been held on an institution's balance sheet directly.

5 In particular, questions remain regarding the proposed treatment of liquidity facilities for asset-backed commercial paper programs, which would face capital charges that seem disproportionately high relative to the level of risk.

6 Some also have argued that the risk weights on such securitized assets are too high as a more general matter. Similarly rated corporate loans often attract a much lower capital charge.

7 For example, banks that qualify for the Advanced IRB approach should be allowed to use internal ratings to determine risk weights, which is not allowed for securitizations under CP3. Ratings based on rating agency methodologies or reasonably equivalent approaches, for example, should provide supervisors sufficient comfort that a market test has been met. Liquidity facilities and credit enhancements for asset-backed commercial paper conduits are prime examples where this approach could be easily adopted.

Cost: The monetary cost of complying with the Basel II rules will be significant. One of our members has estimated that initial costs will be 70 million to 100 million just to implement the system, plus multi-million dollar ongoing costs. If one multiplies these costs by the thousands of banks around the World, this will amount to many billions of dollars of additional costs. Some of these costs will be passed on to consumers and corporations, and some of these costs may force banks to discontinue certain activities leaving these markets to unregulated entities.

A major driver of the cost / benefit ratio of the new rules will depend on how they are applied. For example, there are more than 50 specific requirements that must be met to use the so-called IRB advanced credit system. If each of them is interpreted and tested to rigorous audit standards, there will be enormous costs in compliance though the contribution to better risk management will be small. We would note that implementation costs will also be substantial for regulators as well as for the banking community.

Even more important, perhaps, than the direct monetary costs, are the indirect costs. The latter will depend on whether the new rules support the real risk management needs of the business, or whether they become merely an additional bureaucratic burden or perhaps even a diversion. Our assessment is that most of the additional resources required in order to comply with the new rules will not be in the risk control departments. Instead, most of these new resources will be needed in the areas of financial reporting and IT support systems, in order to generate the volume of data and reports as required by Basel II to a reliable, audit quality standard. While further systems development provide some important benefits, this outcome would suggest that any gains in risk management quality from the new proposal are likely to be relatively modest

Adaptability: The proposed Basel rules are based on the financial markets as they are today. However, the rules are so complex and heavily negotiated that they will be difficult to update over time. Indeed, some have suggested that the Accord will be outdated by the time of implementation.[8]

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[8] See *Risk Magazine*, footnote 3 above.

The draft Accord also requires banks to use the Basel II processes for internal management in many areas, regardless of whether they are relevant for business practices. If bank management is required to compute and manage by the Basel II rules, further improvements in internal practice might be seen as both costly and irrelevant. As a result, the Basel Accord could actually slow the progress and introduction of better private sector risk management techniques.

Proposal: Our suggested response to the problems of prescriptiveness and high cost is for the Basel Committee to place a much greater emphasis on the principles-based approach that underlies the "Pillar II" section of the proposed Accord.[9] Whereas Pillar I sets out regulatory capital calculations in a detailed, prescriptive way, the approach of Pillar II is to force firms to develop their own internal models, based on evolving best-practice, and then to scrutinize the results through the examination process and regulatory guidance. This "principles-based" approach, subject to some reasonable benchmarks and guidelines for consistency, has important natural advantages compared to the complex "black-letter" style rules currently prescribed by regulators under Pillar I. Pillar II encourages banks and regulators to work together over time to improve risk management practice, rather than forcing compliance with a dated rulebook. The latter approach permits steady, evolutionary improvement and should therefore be more durable and relevant than Pillar I rules that are designed with only today's markets in mind.

Addressing this issue will not be simple in the short time left before the rules are finalized. If these rules are all applied as black letter law and interpreted strictly, the new rules will be both costly and potentially irrelevant to ongoing best practice – since the risk management advances that lead in part to Basel II will not end in 2003. We encourage an approach that emphasizes principles and simplicity as the rules are finalized, and a less onerous "trust but verify" approach to compliance. Specifically, we would support adding statements to the Accord to emphasize that compliance with the rules will be based not on "box checking" but on economic content.

[9] Our Pillar II comments here are strictly focused on the credit risk capital charges. As noted later in this testimony, Roundtable members have differing views on whether any operational risk charge should be addressed under Pillar I or Pillar II.

Impact on Competition: We believe that the costly and complex rules of Pillar I will have significant impacts on competition, and could significantly favor certain markets. This will be particularly important in the U.S., where non-bank competitors like investment banks, finance companies and insurance companies make up a large part of the financial system. The Basel rules do not apply to them. If the costs of Basel II are high, banks will earn a lower return on capital, will grow more slowly, and will lose market share. There may even be some incentives to abandon certain businesses or to de-bank altogether. We believe that the Basel Committee needs to do significantly more research in assessing the competitive impact of the rules across the financial marketplace.

Pro-Cyclicality

Our member companies have different views on whether the Basel II Capital regime would significantly increase or decrease equity in the credit markets and ultimately effect the economy. Some of our members believe that the new rules will affect banks' calculation and management of capital during economic downturns, thereby exacerbating liquidity concerns.

Other member companies believe that risk sensitive capital requirements will not impact systemic lending behavior. These companies take the view that pricing decisions and portfolio strategies are driven by internal economic capital models and not actual capital.

We suggest that the Basel Committee add to the proposed Accord an explicit acknowledgment that capital levels may fluctuate, and that Pillar II reviews and stress tests should not become one-way ratchets that only increase regulatory capital requirements. If a stress test is to work properly, then when tough times arrive banks should be permitted to live within their plans, and regulators should resist the temptation to continue to require the same untouched capital cushion.

Operational Risk

In addition to reforming capital charges for credit risk, Basel II establishes a new capital charge for operational risk – the risk of breakdowns in systems and people. This is the most controversial element of the proposed Accord.

It is important to distinguish between the concepts of managing operational risk and imposing a separate, quantitative capital requirement for it. All of the Roundtable's member companies agree that evaluating and controlling operational risk is important and should be required as a supervisory and business matter. Roundtable members do not agree on whether or how operational risk should be reflected in regulatory capital calculations. Many companies believe operational risk can best be addressed through case-by-case supervisory reviews under Pillar II; others favor a quantitative and a publicly disclosed capital charge under Pillar I.

In several forums, the Roundtable itself has opposed a separate capital charge for operational risk, and has argued for handling the issue through supervisory reviews under Pillar II, much as interest rate and liquidity risk are handled. The Roundtable's senior management has expressed its concerns directly to Federal Reserve Board Chairman Greenspan and Vice Chairman Ferguson. Many Roundtable member companies strongly oppose any Pillar I operational risk capital charge. However, several Roundtable member companies just as firmly support Basel II's proposed Pillar I approach, following the development of the Accord's "Advanced Measurement Approach" (AMA), which gives banks flexibility to use their own internal methods for determining the regulatory capital needed for operational risk. Institutions that support a Pillar I operational risk charge believe it would improve transparency and comparability and bring regulatory capital requirements into closer alignment with the "economic capital" determinations used in these banks' internal management decisions. These institutions contend that any approach other than an explicit Pillar I charge for operational risk would impede progress toward a level playing field, by affecting the process of calibrating regulatory capital minimums. That is, these members believe that if an operational risk charge were not included in Pillar I, the resulting capital charges on credit risk and market risk would remain higher to compensate, making it more difficult for international banks to compete with institutions that are not covered by the new Accord.

The Roundtable continues to have concerns about the proposed operational risk capital charge, as well as several technical questions about its implementation. One problem that all of our members agree upon is that the proposed Accord fails to give enough recognition to the benefits of insurance in mitigating operational risk.

Pillar III – Disclosure Rules

One of the strengths of the Basel II proposals is that they look beyond just calculating and maintaining capital levels. In designing Basel II, regulators realized that capital requirements – the so-called "Pillar I" – could never ensure the safety and soundness of the banking system alone. They understood that ultimately it is more important to encourage constructive relationships between financial institutions, their supervisors, and the market to produce good risk management. This reasoning, which has the strong support of the banking industry, has lead to the creation of the two qualitative Pillars of the Basel Accord. Pillar II deals with the supervisory review process and, in particular, regulatory oversight of banks' internal economic risk assessments. Pillar III seeks to enhance market discipline through increased public disclosure requirements.

The <u>concepts</u> behind the proposed rules for Pillar II and III are well accepted by the industry and regulators alike. However, many of the detailed proposals in the Pillar III market disclosures section are cause for concern in the industry. Unfortunately, the development of Pillar III is an area where consultation between the industry and the regulators came late in the process. Although CP3 has improved the situation somewhat, we believe the proposals still are overly prescriptive, burdensome, and subject to misinterpretation. The Pillar III requirements also reflect a somewhat narrow view of risk, focusing exclusively on a specific regulatory view of risk capital.

Some Roundtable banks currently publish approximately 20 pages of risk information in annual reports. We support transparency and disclosure as very worthwhile goals. The Pillar III proposals would add a large mass of additional disclosure which is highly technical in nature and which we believe will be of little benefit to the reader. Indeed, few people are able to digest all of the information that is already presented on risks, but now this information could be lost in a deeper, more technical pile of data. The additional requirements proposed under Pillar III are more likely to confuse than illuminate.

As Chairman Greenspan has recently remarked, transparency is not the same as disclosure: "Transparency challenges market participants not only to provide information, but also to place that information in a context that makes it meaningful."[10] In this, we believe the prescriptive, volume oriented focus of Pillar III falls short.

Of particular concern are the numerous required disclosures that relate directly to the capital calculations performed within Pillar I. Instead of disclosing measures of risk used in internal risk management systems, these disclosures mandate an explicit regulatory capital view of risk. In the most complex areas, such as asset securitization, these disclosures will surely be mystifying to all but the most expert audiences.

Moreover, given the likely longevity of the Basel II Accord (the current Accord is in its 14th year), there is a need to ensure risk management practice is able to mature beyond the concepts now embedded in the Basel II proposals. Just as the market has moved beyond the current accord, there will inevitably come a time when some Pillar I calculations are no longer regarded as good measures of risk for all products. In that case, it must be possible for banks to alter disclosures to represent emerging best practices. Under Pillar III as currently proposed, banks will likely find themselves constrained to disclosing risks under a system that may no longer be wholly relevant.

In designing the details of Pillar III, the Basel Committee has placed too much emphasis on quantity, rather than quality, of disclosure. It is emphasizing consistency by prescription instead of consensus. In contrast, the demands of the market have produced broadly comparable and largely voluntary disclosures of market risk by banks. This is an example of how Pillar III should work. It would be more effective if Pillar III established

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[10] Remarks by Federal Reserve Board Chairman Alan Greenspan, *Corporate Governance*, at the 2003 Conference on Bank Structure and Competition, May 8, 2003.

a general set of principles, and then allowed the discipline of the market to produce continuous improvement in risk disclosure. This would produce information that the market actually desires, rather than seeking to impose today's ideas on future market participants by fiat.

Summary

We are at an important crossroads in the reform effort. A lot of good hard work on designing the framework and gaining political consensus has been accomplished. We have a high regard for the efforts of the Basel Committee and the regulators who have worked so hard to capture the best current practices in risk assessment. The Roundtable has tried to contribute to the specifics of those discussions in a constructive manner. We believe that the current proposal should be streamlined significantly, reducing the level of prescriptiveness and cost, so that the advantages of this project are not tarnished by its current shortcomings. .

Simplifying the massive weight of detailed rules in Pillar I will require continued discipline in the final round of drafting. It will also require a new emphasis on the "spirit" of the rules, both as the rules are finalized and when they move to the implementation phase with national regulators. If, instead, these rules are written and interpreted as black-letter regulations, set at a highly technical audit standard, the cost of overall implementation will be high. Such an approach would mean the calculations could also become increasingly outdated and less relevant to risk management best practice over time. We can hope that all national regulators will avoid this pitfall, but international banks will tend to be driven by the standards set by the strictest and most literal of their major regulators.

Much hard work has been put into Basel II, but much also remains ahead. The timetable for implementation is challenging, particularly since the Accords requires a minimum of three years of data for the advanced calculations – meaning that banks will need to revise systems to begin collecting the new information by early next year. In the pressure to finalize and implement the Accord, we hope that enough time will be provided for everyone – banks and supervisors alike – to digest and think about the implications of the new regime, and to develop appropriate transition rules.

As a final comment, I believe that much more can be accomplished by increasing the emphasis on the concepts of Pillar II and Pillar III, and a focus on the principles of evolving best practices rather than fixed formulae. This approach would not only help address "prescriptiveness, cost and adaptability", but could also help address the issues of operational risk and pro-cyclicality. Pillars II and III have real people on the other side – regulators and the market. Human judgment can adapt to changes and new markets more easily than a rulebook can. This approach, properly applied, also puts the burden back where it should be – on the shoulders of bank management to demonstrate to the regulators and the public that they are doing a good job. That is in the spirit of the Sarbanes-Oxley reforms, and I think it is a smart, durable way to improve discipline and maintain best practice standards.

Lastly, it should also make the new system more responsive to change and therefore more relevant over time. Without adjustments to make Basel II more flexible and to allow it to evolve over time, there may be a need to revise Basel II within a shorter time period than desirable.

Thank you for your consideration and we look forward to working with the BIS Committee and U.S. regulators to refine and improve Basel II before its ultimate implementation.

Sincerely,

Richard M. Whiting

Richard M. Whiting