STATEMENT OF CHAIRMAN SPENCER BACHUS SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT "THE BASEL ACCORD; PRIVATE SECTOR PERSPECTIVES"

Good morning. The subcommittee will come to order. Today we will hold a hearing entitled "The Basel Accord; Private Sector Perspectives." At the end of this week, financial regulators from around the world will release the newly negotiated Basel Capital Accord, or Basel II. This Accord has been heavily negotiated over the past several years and there has been a lot of progress made along the way. However, there are still several critical changes that should be made before the U.S. financial regulators adopt Basel II.

This is the third hearing that the Financial Services Committee has held on the new Accord. Prior hearings highlighted disagreements among the federal financial regulators and led to this Subcommittee's mark-up of H.R. 2043, "the United States Financial Policy Committee For Fair Capital Standards Act," legislation which would mandate the development of unified U.S. position prior to negotiating at the Bank for International Settlements. Following Subcommittee approval of H.R. 2043 by a vote of 42-0, I have seen more cooperation among the regulators and an increased sensitivity to the opinions and perspectives of all the stakeholders in these negotiations. I hope that this cooperation continues and that the federal regulators work together in the best interests of the U.S. banking sector, and the U.S. economy.

There is broad agreement that the first Basel Accord needed improvement. The global banking system has changed significantly since Basel and the old ways of measuring risk are simply inefficient. What has developed through the Basel II process is state of the art in risk assessment. However, there are several significant issues that should still be addressed before the U.S. endorses Basel II. The leadership of the Financial Services Committee submitted a comment letter to the federal regulators raising several concerns with the Basel II proposal and the related ANPR. Concerns related to operational risk, the risk weight for commercial real estate loans, and the impact this accord will have on competition and consolidation within the financial sector were all raised by this committee and none of them has been adequately addressed.

Under Basel II, banks will be required to take on a new mandatory capital charge for operational risk. This new charge will require banks to hold capital against losses resulting from inadequate or failed internal processes, people and systems, or from external events. This definition includes losses resulting from failure to comply with laws as well as prudent ethical standards and contractual obligations, as well as litigation risk. I have heard from several financial institutions that there is not a widely accepted way to measure these losses and that efforts to quantify operational risk losses are in the very early stages. I would recommend that the Basel Committee seriously consider not making the operational risk charge a mandatory one, but rather one that is set on a case by case basis by the regulator. Because Operational risk is so difficult to define it makes sense for a regulator to "know it when they see it" and then set a capital charge as opposed to mandating the charge. The federal regulators often claim that the Basel II proposal will continue to evolve and be flexible. If that is truly the case shouldn't an operational risk charge evolve from Pillar II treatment to Pillar I treatment once it has become easier to measure?

The U.S. commercial real estate market has proven to be strong and a key driver of our economy. I am concerned that as drafted Basel II will require a 25% risk weight increase for some acquisition, development and construction loans. This is highly problematic as it will likely drive banks out of this type of lending, stifling economic growth. There have been tremendous advances in the assessment of risk for this type of lending, unfortunately the Basel Committee is not talking into consideration these important advancements and is applying an unsophisticated standard for the risks associated with an important lending sector. I am concerned that the real goal here is to improve risk management in Europe, Asia, and other parts of the world, however, U.S. lenders will be negatively impacted even though they follow state of the art risk management techniques in acquisition, development and construction lending.

Competition in markets is key to ensuring that innovation is encouraged, services are available, and prices are kept low. The Basel II accord is going to apply only to the largest financial institutions in the U.S. However, there are some institutions that will see compliance as a requirement to remain competitive while others simply will not have the resources or expertise to comply with Basel II. My concern is that this two tiered system will, through regulation, force banks to merge, sell, or change their business models. This could mean a reduction in access to financial products to some, and an increase in costs for consumers, all because of a regulatory regime that was negotiated outside of the political process. Basel II has the potential to radically change the way banking is done in the U.S. I understand that the Federal Reserve has issued a white paper on this subject, however it is my understanding that this white paper looks back at the effect of previous regulatory decisions on industry consolidation, not forward. The fact is that that none of the regulators actually knows what effect Basel II will have on the U.S. industry. I find it troubling that our regulators would be willing to assent to such an agreement before they conduct a fourth qualitative impact study which is scheduled for this fall. Why not get the results of this study before agreeing to Basel II? What is the rush? If we are going to radically change the way banks assess their capital shouldn't we look to what the impact will be on these institutions before signing on the dotted line?

I want to thank the witnesses for appearing today. We have a diverse panel and I look forward to hearing your perspectives on the Basel II Accord.