As the program says, I'm retired. I no longer speak for the Fed. However, I think I am the token speaker that has been invited by our hosts to support Basel II. I do so sincerely.

I was present at the birth of Basel I that began as an agreement between the Fed and the Bank of England to require all banks—domestic and foreign—operating in their markets to meet certain capital standards. Both central banks were interested in inducing under-capitalized foreign banks operating in their markets to strengthen their capital in order to address their own banks' complaints that US and UK regulatory efforts to strengthen home country banks' capital put them at a competitive disadvantage vis-à-vis foreign banks. Other national regulatory agencies, concerned about being left behind wanted to join in the common set of rules and the UK-US effort thus became further internationalized and modified at Basel to meet common needs. The result was Basel I.

Please note three things. First, there was not much risk sensitivity in Basel I; it really was not the objective. Second, the minimum regulatory capital requirements under Basel I were arbitrarily chosen, mainly on the standard of whether they could be met politically. They were not based on any consistent, risk-sensitive, analytical framework or empirical analysis, even though they have now obtained religious significance among many observers. Third, Basel I in 1988 and Prompt Corrective Action and FIDICA in 1991, both led undoubtedly to an increase in capital actually held, including an increase in the capital held above minimum regulatory levels. But, nonetheless, in evaluating this capital buffer, it would, in my view, be an error if one did not also give significant weight to two other factors, totally independent of regulatory rules: (1) the near death experience of the US banking system in the 80s, the result of which was management and market demands for capital strength, and (2) the increasing importance of the rating agencies for global banks as they rely more on non-deposit funding and engage in non-traditional finance.

While actual capital held depends on more than regulatory capital requirements, the regulatory minimums are not unimportant and the efficacy of Basel I requirements at global banks has been overtaken by the increasing scale and sophistication of these institutions. Developments over the last 15 or so years have simply made Basel I regulatory capital rules virtually useless at the largest banks. Of course, the most critical of these developments is capital arbitrage. Broadly speaking, capital arbitrage arises when a bank chooses to sell, or simply chooses not to acquire, safer assets whose *economic or market* capital charge is less than the *regulatory* charge, while retaining or acquiring assets whose *regulatory* capital charge is less than the *economic or market* capital requirement. That is, banks can keep their *regulatory* capital ratios looking better than their portfolio risks might suggest.

Capital arbitrage, mainly conducted by global banks, began and continued while another important trend was underway—the increasing concentration of the banking system in the hands of a few megabanks. Some alarm bells should be ringing someplace when a concentrated set of giant global banks, all perceived to be protected by one form or another of a governmental safety net, entering new markets and developing new and untried kinds of financial transactions, difficulties at anyone of which could cause significant market disruptions, have increasingly meaningless regulatory capital ratios.

Indeed, a revolution in banking has been underway with a broken regulatory capital system.

So what? After all, there are a couple of reasons not to be concerned that regulatory capital ratios have been manipulated. First, as I have noted, the market and perhaps the rating agencies have imposed higher actual, although non-regulatory, capital requirements on a bank management that has learned the benefits of a capital buffer for flexibility and reduced funding costs. Second, the mega-bankers tell us that they have developed formal risk measurement and management techniques to manage risk and to allocate internal economic capital rationally. Not to worry about the increasingly irrelevant Basel I capital ratios because banks now know how to take risk better than ever.

I'm made somewhat more comfortable by better risk measurement and management by banks, by the market capital requirements, and by the lessons learned from the 80s. But, risk management by banks is not based on supervisory risk standards. Indeed, in taking on and managing risk, bank management decisions are distorted by the subsidy in the safety net that insulate the banks from important market pressures and signals. And, bank balance sheets remain opaque, despite some improvement in disclosure, further distorting market signals. Finally, bankers that were scared by the past are dying and retiring. All of these factors undermine my comfort level. Here's why.

First, manipulations of regulatory capital ratios through capital arbitrage can and does mislead supervisors and policymakers and provides a false sense of security to the market. Second, these distortions undermine the effectiveness of prompt corrective action trip wires and may well lead to well-intentioned supervisory error.

Because of original design objectives and capital arbitrage, Basel I does not come anywhere near close enough to measuring risk with meaningful sensitivity. If one believes, as I do, that we need to have a risk-sensitive capital system, we would accept the idea that banks with safer portfolios should have lower capital requirements and those with riskier portfolios should have higher requirements and not only would that be alright, it would be safer and sounder than what we have now. Not only would such risk differences be reflected in minimum regulatory capital requirements, but disclosures also would be designed to induce the market to help establish more risk sensitive levels of capital actually held and rating agencies to establish better ratings as well. I believe that any regulatory capital standard that is inconsistent with such results is both inefficient and counterproductive.

Most of us would agree that what I have just described is highly desirable and, in a perfect world, we would instruct bankers to estimate their best risk models and apply those models to determine the *regulatory* capital requirements to meet supervisory imposed soundness standards for banks of their scale. Moreover, in this perfect world, bankers would use exactly these same measures to determine their internal economic capital allocation, how much aggregate capital (including buffers) they would actually hold for their own purposes, how to price their credit exposures, and how to choose among their credit risk options.

Well, it turns out the world ain't perfect. First of all the world doesn't like change that undermines the status quo. Second, developing the processes and standards of the perfect world, and even the less than perfect Basel II world, would be costly for those to whom it would be applied. Many of those that have to approve cost increases are neither students of risk management nor have the incentives to become so. Many of those that have to do the applying, like supervisors, I might add, feel a bit threatened as well by the changes implied and their managers are every bit as worried about the costs as are the bankers. Finally, costs aside, and most important, dwarfing perhaps the other factors, there is no consensus, even within the banking system, on the best *practical* way to measure risk, given the lack of data. Perfect worlds are not just around the corner.

Thus, if we are to have a better regulatory capital standard in a competitive world, the reality is that Government, that is, the banking agencies, is under a practical mandate to adopt rules and impose standards that will treat similar banks similarly. That means that regulators are forced to write rules and clarifications, make assumptions, and engage in trade-offs that, in a complicated world, result in complicated proposals that will, by the nature of the beast, continue to evolve as we learn more and as technology changes. That anyone should be surprised by that surprises me. My hope is that experience will allow future modifications and variations in the rules that will get us closer to that perfect world. My biggest fear is that in the interim Basel II might become a compliance exercise in meeting a set of rules. But rules there have to be.

Benefits and fears aside, it seems to me that there should also be no surprise that the comments on the Basel proposed rules should reflect self-interest. Let me underline that individual bankers and banking groups have been incredibly helpful, proving good ideas and refining the proposal in positive ways. Moreover, I am convinced, that as we get closer to the effective date and as we go live with Basel II, bankers will continue to help us revise the rules. But bank objectives are not—and should not—always be the same as the public interest, and bank comments, just like those of others, need to be evaluated in light of that reality. For example, recall, please, that US supervisors had earlier decided, quite rationally in terms of risk, market implications, and cost-benefit analysis, that neither (1) the use of the foundation and standardized versions nor (2) application of the advanced approaches beyond the megabanks made much sense. Some megabanks now want the softer versions because they fear too little capital break per dollar of cost to them of applying the advanced approach. That is, they want an assured prize for their effort or they don't want to play. Basel II may be less risk-sensitive than it should be. Supervisors may be too fearful of declines in capital until they are more comfortable with the new rules in action. But comparison of bank costs to bank benefits (not public benefits) should be a second or third order public interest criterion, I believe.

Meanwhile, the smaller banks, dreadfully afraid that someone somewhere will be getting a goody they won't get, want the reductions in capital charges of Basel II with none of the risk management requirements and costs, including the higher capital charge on riskier assets. They will get their goodys, too, under Basel IA. Is this a great country or what?

I'm not opposed to greater risk sensitivity at smaller banks, even if it's not a totally two way street. However, I'm reasonably sure that community banks face no competitive disadvantage from megabank adoption of advanced Basel II because capital arbitrage has already reduced large bank capital ratios relative to their own. Moreover, pricing is more determined by economic and market capital than regulatory capital. The saving grace is that the *regulatory* capital reduction we will give community banks under Basel IA will almost certainly have little effect on the amount of *actual* capital they will hold. Indeed, for most community banks, an *elimination* of regulatory capital would have no effect either. Somewhat more risk sensitivity at these institutions is fine, but it really isn't going to make a lot of difference to them or to financial markets or on failure rates. Regionals excluded, of course, where some kind of middle ground might be desirable, although I guess market forces will move them in the Basel II direction anyway, if its required of megabanks.

If the larger banks win the political fight to adopt weaker versions of Basel II, the loss to the public interest will not be so much in the poorer measures of regulatory risk-based capital requirements, although as I noted, that will present some problems. In my view, the actual capital held will be only marginally affected. Rather, the loss will be in the effort to move both banks and supervisors toward stronger analytical, quantitative, risk measurement and management techniques, and to assure that counterparties are provided better disclosures to assess banks' riskiness, enhancing market discipline. Loss of such momentum in an increasingly concentrated banking system with a safety net for megabanks should, in my view, scare the hell out of interested observers. It appears not to be doing so.

Let me return briefly to the concern about the level of *regulatory* capital requirements under Basels I and II. Supervisors have a natural and understandable inclination to think that no reduction in capital from any level is desirable—even if, as I mentioned, the current level is both arbitrary and increasingly distorted by capital arbitrage. Bankers, on the other hand, seem to believe that no level of regulatory capital is low enough and that any regulatory cost has to be rewarded with reductions in regulatory capital requirements. As I have already opined *ad naseaum*, both sides are, I think, putting too much emphasis on regulatory minimums and not focusing on the level of economic and market capital requirements that are only loosely related to the regulatory levels. Regulatory minimums should be as right as we can get them, they may fall or rise from current levels, but far more important, I think, is getting the relative charges right and truly reflecting risk, disclosing the proper risk measures to help the market get it right, and—most important—assuring as best we can that risk measurement and management at large banks is being used in a way that the supervisors find desirable for the safety and soundness of banks.

If we over focus on the level of regulatory capital under Basel II or if we let megabankers avoid adopting the tough and hard measures needed, then we will have lost an important opportunity. There are surely adjustments that would improve Basel II to address concerns of interested parties. But two factors I believe must be underlined. First, it is time to call some of the criticisms what they are—self-interest pleading—and address them in the public interest. Second, it is time to come to grips with the fact that the *status quo* is untenable. Basel I for megabanks just ain't broke, it's increasingly irrelevant and has to be replaced with an approach that is truly risk-based and that focuses on risk measurement and management. Basel II is the best approach that has come along so far and we should, in my view, get on with the job.

Let me be clear, however, that I do not mean getting on with the job means necessarily adopting the proposal in its present form. The agencies have to continue taking *constructive* suggestions seriously. Two areas for improvement come to mind. First, we should see if there are ways to reduce procyclicality without giving up too much supervisory comfort. Second, we should explore once again if there are ways to reduce implementation burden without sacrificing too much risk sensitivity, perhaps by reducing prescriptiveness. *To accomplish these changes will require the megabanks to help by trying to develop a non-self-serving consensus that the agencies can embrace. Sadly, the political reality is that a Basel-weary burned-out civil service may not be able to make adjustments without such assistance.* A US Basel II is likely to go forward with or without such help. The saving grace may well be that during the long transition period—with its floors and potential holds—changes will be made. It may not be the most efficient and cost-effective way to do it, but it is probably the way that it's going to get done.