It is a pleasure, Mr. Chairman, to appear before this Subcommittee and present our concerns on the revised Basel Capital Accord. I am Sarah Moore, and I am Executive Vice President and Chief Operations Officer of The Colonial BancGroup, Inc. Colonial BancGroup is the holding company for Colonial Bank, a state-chartered, Federal Reserve member bank. We are headquartered in Montgomery, Alabama, and maintain banking offices in Florida, Alabama, Georgia, Tennessee, Texas and Nevada, with a total of 273 locations. As of year-end 2002, we had approximately $15.8 billion of assets.

We anticipate the impact of the new Accord will be far-reaching, as it will affect not just the largest banks; rather, its effects will be felt by banks of all sizes. Moreover, it will have a measurable effect on the nation's economy as well. We appreciate the Subcommittee's foresight in undertaking to examine the effects of the Accord, and we applaud the Subcommittee for giving this matter the priority it deserves.

The revised Basel Capital Accord is a formidably complex document. We believe Basel II will have the unintended consequence of giving the largest U.S. banks an unwarranted competitive advantage over smaller institutions that compete against them, and, additionally, will place all U.S. banks at a competitive disadvantage to nonbanks and to foreign banks. We further believe that, as drafted, Basel II will lead to loss of credit opportunities in the real estate sector, since the Accord treats lending to this area in an unreasonably disparate manner. It is foreseeable that, as a result, financial institutions will divert their resources away from real estate lending, preferring instead to make loans to those sectors that are not as "capital expensive."

In light of these and other issues created by the revised Accord, we urge the Congress to exercise appropriate oversight of any proposed international capital accord with the members of the supervisory committee of the Bank for International Settlements, and urge that it do so by imposing the requirement that, prior to agency action on any such international agreement on capital standards, the Federal banking agencies (in consultation with the Secretary of the Treasury) thoroughly evaluate the impact of such agreement and submit a joint report to the Committee on Financial Services of the House of Representatives, describing their joint findings and the merits of the proposed agreement.

TREATMENT OF REAL ESTATE

The most problematic issue in the proposed New Basel Capital Accord for Colonial Bank and other regional banks is the proposed treatment of commercial real estate and the resulting impact on our bank, our customers, and the economy. Regional and community banks such as Colonial provide most of the commercial real estate lending in the southern United States. The Accord is intended to provide an incentive for banks, in the form of lower capital requirements, to employ sophisticated loan portfolio modeling techniques, loss migration tracking tools, and risk modeling tools, all of which are part of what the Accord calls the "Internal Ratings Based Approach" to calculating credit risk.

Its proponents have argued that the Accord will reduce the capital requirements for certain banks; however, with respect to real estate lending, not all banks will be able to utilize the tools under the Accord for this purpose. While all other types of lending can utilize the tools

envisioned under the Accord, real estate lending is treated disparately. Commercial real estate lending is identified in the Accord as a more volatile, higher-risk type of lending than every other type of lending. Banks that use these risk-assessment tools to measure the performance of their real estate portfolios cannot – regardless of the performance of those portfolios – gain entitlement to lowered capital requirements, as the Accord allows them to do in respect to every other type of lending.

In fact, the drafters have chosen to set risk weights on these assets, without room for adjustment, at substantially higher levels than on loans to other sectors. As a result of this arbitrary characterization of real estate lending, and despite the millions of dollars that will be spent in developing the models and tools needed to comply with the Accord, banks will not be permitted under the Accord to adjust their capital levels to reflect the actual risk level posed by real estate lending as determined by the tools themselves. This treatment discourages participation by banks in the real estate sector, since such lending will carry an unreasonably higher capital expense when compared to a bank's other lending opportunities.

"Asset correlation" is cited as the primary reason that commercial real estate loans are carved out from all other types of loans and are assigned a higher risk rating. The drafters of the Accord state that commercial real estate loans have a tendency to default in "clumps," and that it therefore is more likely that a large group of individual loans would default together and produce a large portfolio loss. We submit that it may just as easily be posited that many other types of loans exhibit similarly high levels of asset correlation, as we have seen recently in the

technology, telecommunications, and airline industries, to name a few; yet loans to those industries are not singled out for higher risk weightings.

At the end of the day, regardless of the type of lending, the best measure of how soundly banks lend money is to review net charge-off ratios over time. Why didn't the Basel Committee use net charge-off data for all U.S. banks to develop risk-based capital allocations? I'll tell you. The numbers do not support the capital treatment provided under the new Accord. This is made quite clear in the graph that we have submitted as a part of this testimony.

This graph illustrates net charge-offs by loan type for all commercial banks, from 1985 through the 3rd quarter of 2002. You can see from the data that since 1995, commercial real estate loans have experienced lower net charge-offs than consumer loans and commercial loans, yet, under the Accord, banks must carry higher levels of capital for commercial real estate loans than for those types of loans.

Much of the bias against commercial real estate lending is based on the losses in commercial real estate that were incurred during the 1980's. Since then, much has changed. New laws and regulations, improved bank underwriting standards such as minimum debt-coverage ratios, cash-flow analyses, independent appraisals, proactive management of nonperforming assets, and increased sophistication in market information, have worked in concert to improve banks' commercial real estate lending. The net result has been low net charge-offs in commercial real estate over the past ten years. Again, I would refer you to the graph submitted with this testimony.

In an interesting twist in the Accord, we have found that if a borrower has a good credit rating, it will be less burdensome for a bank to make unsecured loans to that borrower, than to make loans collateralized by real estate to that same borrower. Under Basel II, a bank that makes an unsecured loan to a corporate borrower with a Moody's "A" credit rating will be required to maintain less capital than it will for a loan in the same amount, to the same corporate borrower, that is secured by commercial real estate.

Let's walk through an example of how a commercial real estate loan is treated under the New Accord, versus an unsecured loan to WorldCom. Assume we have a $100,000 loan collateralized by a fully leased office building. Let's assume also that the borrower has good repayment history and that the loan is performing as agreed. The rating assigned to the loan is satisfactory. This loan will carry a capital charge of $8,000. By contrast, a $100,000 unsecured loan to WorldCom, which had a Moody's credit rating of "A2" prior to the company's announcement of accounting irregularities, would have carried a capital charge of only $1,600. Which one do you perceive as higher-risk: a loan collateralized by real estate that you can touch and resell, or a promise to pay from a telecommunications company? The disparity in capital requirements under the most basic approach in the new Accord is startling . . . the disparity increases dramatically as you move along the risk-management continuum.

While the Accord is intended to strengthen banks, in this instance it encourages making unsecured loans rather than secured loans. Encouraging banks to choose unsecured lending over secured lending is certainly not the way to add strength to a banking system. What will this

mean to our bank, our customers, and the overall economy? As a result of the higher capital requirements, there may be less credit available for the industry, and it will be provided at a higher price. Our fear and your fear should be that lack of credit availability, combined with the increased prices necessarily charged to commercial real estate borrowers, could reduce growth, opportunities, and employment in the economy.

COMPETITIVE DISADVANTAGES UNDER THE REVISED ACCORD

Although there have been public statements by regulators that Basel II will apply only to the twenty largest banks in the U.S., in reality regional banks are being told to prepare to put into place the advanced methodologies set forth in the Accord. Even if the Accord were to apply only to the largest banks, it would not mean that smaller institutions will not feel its effects. Under Basel II, there are two methods by which a bank may calculate its risk weights. These approaches are the Internal Ratings Based Approach, and the Standardized Approach.

Under the more sophisticated Internal Ratings Based Approach, a bank will be allowed to determine its risk weight (and, therefore, its capital requirement) for each asset, e.g., a loan, based on its own internal data. Approval to use this approach is not obtained easily or inexpensively, however, because banks seeking to use the Internal Ratings Based Approach are required to dedicate a significant amount of resources, both human and economic, in order to deploy the systems required for its use. Banks that cannot or will not make this substantial investment will be required to use the Standardized Approach.

Under this method, a bank's regulators will largely determine what its capital requirements are by assigning a range of possible asset risk weights for the bank to apply, based on the types of loans and assets that the institution holds. This approach is similar to the method utilized under the current Accord. Unfortunately, the existence of this dual system puts small and medium-sized banks at a competitive disadvantage to their larger brethren, namely, those banks in the top twenty.

For example, there will be times that a larger bank, utilizing the advanced approach, will have a lesser capital requirement for a particular loan than would a bank of smaller size that utilizes either the Standardized Approach or follows current guidelines. As a result, the larger bank, because of the less stringent capital requirement to which it is subject, will be able to charge a lower interest rate, on the exact same loan, than a smaller bank can charge. Thus, the Accord automatically provides the larger bank with a distinct competitive advantage in loan pricing.

A further result is that the larger bank, not being limited by the increased capital requirement imposed on the smaller bank, also is able to support a greater volume of earning assets with the same amount of capital, thereby placing smaller competitors at an even greater disadvantage. The result is that the larger bank can achieve higher returns on its capital than the smaller competing institution.

Obviously, these inequalities could be eliminated if all institutions could use the more sophisticated Internal Ratings Based Approach. Indeed, our regulators have informed us that we

may voluntarily follow the revised Accord's processes and thus implement this system. However, the numerous requirements that must be met in order to satisfy the criteria for utilizing the Internal Ratings Based Approach mean that any potential benefits thereunder would be eroded by the cost to our bank of acquiring the necessary systems, software, and personnel that the Approach mandates.

As it stands today, only the largest institutions have the resources that would enable them to employ, on a cost-effective basis, the extensive measures required by the Internal Ratings Based Approach.

The proposed Accord also would create an uneven playing field as a result of the lending patterns of the largest banks in the country, compared to those of regional and community banks. At all holding companies having assets over $200 billion, as of September 30, 2002, commercial real estate loans, as a percent of total loans, was only 5.3 percent. On the other hand, at all holding companies under $15 billion, on the same date, the percentage of commercial real estate loans was 10.7 percent. Thus, the Accord's automatically harsh treatment of commercial real estate lending disadvantages smaller institutions far more than larger institutions.

This disparate impact is particularly pronounced when one reviews the relevant data for individual banks in this regard. Below are the percentages for the listed institutions as of September 30, 2002:

Bank:		Commercial Real Estate Portfolio Percentage:
Citibank	--	1.0%
J.P. Morgan Chase	--	1.6%
North Fork	--	19.79%
Wachovia	--	13.6%
Colonial	--	27.1%
Regions	--	20.1%
SouthTrust	--	24.7%
Cullen Frost	--	20.99%
Zions	--	28.7%

MARKET CAPITALIZATION

Another consequence of the dual system for calculating risk weights that causes us concern is the potential for negative market perception toward banks that do not adopt the more sophisticated approaches set forth in Basel II. Any perceived lack of sophistication in bank management could lead to a sell-off of an institution's shares. Thus, even if the Accord may apply only to the top twenty banks, smaller institutions wishing to avoid any such perception may feel market pressure to voluntarily adopt Basel II's provisions. If, as a result of insufficient resources, they cannot do so, they likely will see their market capitalization decline, based on a perceived lack of sophistication. Thus, the very supervisory tool that is meant to bolster bank capital may in fact have the directly opposite result.

ENFORCEMENT ISSUES

Finally, as an internationally active bank we believe there is one further issue that we must call to your attention. An undesirable circumstance encountered by the original Accord, which continues to this day, is the inconsistent manner in which, first, different countries define "capital" under their accounting systems, and, second, their regulators enforce the capital requirements of Basel I.

By effectively broadening the scope of what constitutes capital, certain countries have allowed their banks to claim adherence to the standards imposed by the original Accord, while, in truth, their capital levels are quite thin. For example, as we speak, Japanese banks are allowed to count as capital certain tax-deferred assets. According to Japan's tax-deferred accounting rules, banks can count as capital taxes that were overpaid but that will be returned in the future in the form of tax breaks.

As *The Wall Street Journal* reported on October 30 of last year, "The [Japanese] regulations allow bank capital to be crammed with squishy stuff like potential tax credits and securities the banks will have to redeem in the future . . . as harder types of capital, such as shareholders' equity, are eroded by losses on bad loans and declining stock prices." Despite reports that many of Japan's largest banks are under water, their capital ratios are still touted as being in compliance with the requirements of the original Accord. As a result, the risk-taking activities of these banks are not adequately measured by the Accord, and thus they are not held to

the same standards as U.S. banks. International competition is skewed in their favor because of Japan's lax enforcement of the Accord.

As with enforcement of the original Accord, we fear that the revised Accord will be enforced by some countries in a similarly haphazard manner. Because of such inconsistent enforcement, we fear the goal of attaining a true international banking standard, with equal competitive footing, will not be achieved.

CONCLUSION

Let me conclude by saying that the United States banking system is unlike any other in the world. Our system, ranging from small community banks, to regional banks, to large multinational banks, is without parallel in the global community. Moreover, the fact that all of these institutions, of various sizes, can compete equally in the same U.S. marketplace is a testament to our nation's system of free enterprise. Unfortunately, it appears the drafters of the revised Accord have not taken such a unique banking system into account.

As a result of the inherent flaws in the Accord, if it is allowed to remain in its present form, it will benefit only a handful of the largest U.S. banks, while the majority of community and regional banks will be burdened by higher capital requirements and increased expenses. Moreover, the disparate treatment of commercial real estate lending will manifest itself through significant credit crunches and dismal economic performance.

With that in mind, we urge the Congress to require that, prior to agency action on any international agreement on capital standards with members of the supervisory committee of the Bank for International Settlements, the Federal banking agencies (in consultation with the Secretary of Treasury) evaluate the impact of any such proposed agreement, taking into account the following factors:

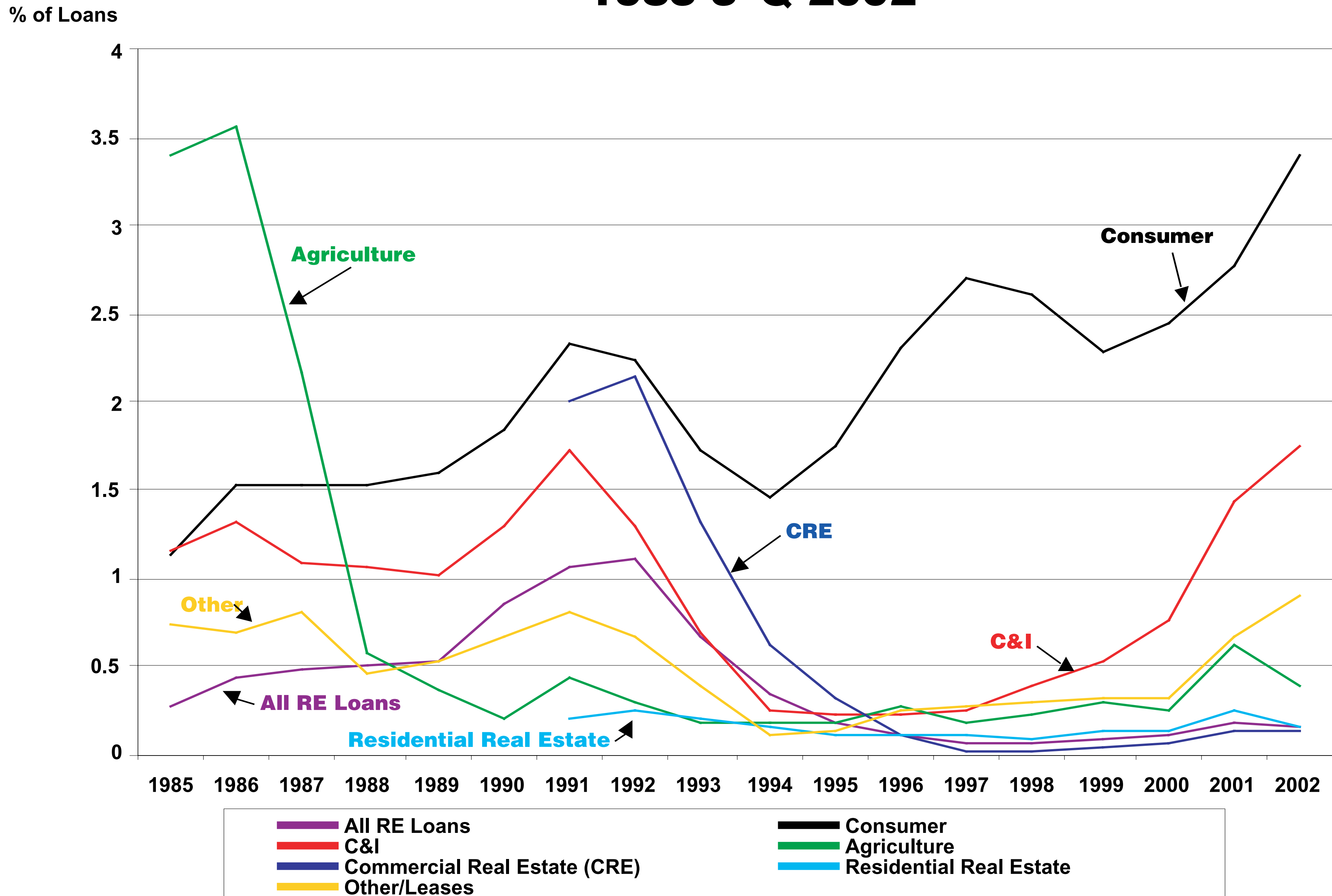
1. The cost and complexity of the proposal;
2. The impact of the proposal on small and medium-sized financial institutions;
3. The impact of the proposal on real estate markets;
4. The merits of an operational risk standard;
5. The impact of the proposal on competition between banks and nonbanks;
6. The need for additional training for supervision and examination personnel; and
7. Any comments submitted by the public after a notice and comment period of not less than 60 days.

We further urge that the Congress require the agencies (in consultation with the Secretary of Treasury), upon their completion of such evaluation, to submit a joint report to the Committee on Financial Services of the House of Representatives, addressing the foregoing factors and describing their joint findings on the merits of the proposed international capital agreement.

I thank the Subcommittee once again for the opportunity to be heard today, and for allowing me to express the views and concerns of my colleagues on the revised Basel Capital Accord.

See Attachment: Annual Net Charge-off Rates 1985-3rdQ 2002

Annual Net Charge-off Rates
1985-3rdQ 2002



Source: Charge-off Rates, All Banks, Not Seasonally Adjusted from Federal Reserve Web site: www.federalreserve.gov