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America's Community Bankers

on

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Chairman Bachus, Ranking Member Sanders, and members of the Subcommittee, my name is Kathleen Marinangel. I am Chairman, President and Chief Executive Officer of McHenry Savings Bank, a $250 million community bank located in McHenry, Illinois. McHenry Savings Bank is a state-chartered, community financial institution serving customers in McHenry County in Northeastern Illinois. The bank currently operates five full-service banking offices. The primary business lines of the bank are focused on retail customers and small business owners, resulting in a diversified portfolio of single family mortgages and commercial and consumer loans. We compete head-to-head throughout our market area with many large national financial institutions, including Washington Mutual, Citibank, JP Morgan Chase, Fifth Third, and TCF National Bank. We also compete with large foreign-owned banks such as Harris Bank, LaSalle Bank and Charter One.

I am testifying today on behalf of America's Community Bankers, where I serve as a member of the Board of Directors and on several committees. Thank you for this opportunity to testify on the priorities of community banks for Basel reform. ACB and its members have taken the lead for some time now in raising issues about Basel II and requesting simultaneous changes to Basel I. ACB has expressed concern about the impact that Basel II will have on community banks from a competitive perspective, as well as what effect the Accord will have on consolidation and merger activity in the financial services sector. We also have expressed concern about the complexity of the proposal and the impact it could have on the safety and soundness of the U.S. banking system.

We believe that the development and implementation of the Basel II Accord is one of the most important regulatory initiatives for community banks today. The U.S. financial regulators intend to implement Basel II in a manner that will for the first time create a bifurcated regulatory capital framework in the United States. As currently contemplated, only about 10 banks in the United States would be required to comply with Basel II. An additional 10 to 15 believe that they have the resources to voluntarily comply. All other banks and savings associations would remain subject to Basel I. This proposed implementation strategy and the results of the most recent quantitative impact study for Basel II show the importance of Congressional oversight over this process.

I would like to make two important points at the outset of my testimony. U.S. bank regulators will be attending the regular quarterly meeting of the Basel Committee on Banking Supervision next week. Our understanding of the process in Europe is that the European Parliament plans to move ahead on Basel II implementation and because of the unique governmental structure created by the EU, legislators feel they must make some decisions about the specifics of the new capital requirements fairly soon. Because the European framework provides limited flexibility to make changes to Basel II in the future once these final decisions are made, European banking supervisors are pressing for agreement as to specifics on Basel II. We believe strongly that the U.S. regulators should make no commitments to their foreign counterparts next week in light of the still evolving nature of Basel II implementation in the United States. As our regulators continue to review the results of the most recent quantitative impact study, they need the flexibility to make changes to Basel II as circumstances dictate to ensure the safety and soundness of the U.S. banking system as well as to maintain a level competitive playing field.

While we understand that there needs to be coordination and cooperation with European counterparts to the extent possible, no legislative or regulatory process in the European countries should dictate the timing of how the U.S. regulators proceed here in the United States.

The other point I would like to make is to commend the U.S. financial regulators for initiating a dialogue with representatives of the banking industry about developing a Basel Ia for the institutions that will not be subject to Basel II. The industry had a very productive meeting with regulatory staff back in July to discuss the revision of capital requirements. The industry was able to provide helpful information to the staff about the influence that capital requirements have on an institution's business strategy and the kinds of changes that could make Basel I more risk sensitive without adding too much regulatory burden. We found the staff very willing to listen to the industry's perspectives. Our understanding is that the regulators will soon issue an Advance Notice of Proposed Rulemaking to solicit additional information and comment on proposals to revise Basel I.

It is vital that the federal financial institution agencies continue to work on the development of a Basel Ia that provides more risk sensitive capital requirements for those United States financial institutions that cannot or are not permitted to comply with Basel II. We also believe that as Basel II implementation and Basel I revisions move forward, it is essential for Congress to remain engaged and to play an active role, as this committee is doing so ably. Nothing could be more important to the future of the U.S. banking system than the capital requirements necessary to ensure the safety and soundness and economic health of the banking industry and, in turn, the broader economy.

Basel II Accord

Let me turn to a discussion of the Basel II Accord and ACB's concerns and position. ACB does not oppose implementation of Basel II. As we testified before the Subcommittee on Financial Institutions and Consumer Credit last spring and before that almost a year ago, we support the efforts of U.S. and global bank supervisors to more closely link minimum capital requirements with an institution's risk profile. This approach could increase the safety and soundness of the banking industry and allow institutions to deploy capital more efficiently.

We do have significant concerns about the complexity of the proposal and the ability of financial institutions to understand and implement, and supervisors to adequately administer and enforce, the proposed new capital requirements. Although the current version of Basel II is less detailed than previous versions, it remains extremely complex. Because adequate capital is so important to the global financial community, the inability to properly implement, supervise and enforce capital requirements can lead to significant safety and soundness issues.

Therefore, we believe that prior to adoption, legislators, regulators and the industry need to evaluate the complexity of the proposal and the ability to monitor compliance. More examination needs to be made into the real-world consequences of adopting an extremely complicated capital regime, including the resources needed for implementation, the problems inherent in on-going maintenance, the likelihood of effective regulation and market oversight, and the competitive pressures that could encourage banks to game the system.

We understand that the U.S. regulators currently propose to leave a leverage requirement in place. We believe that a regulatory capital floor must remain in place to mitigate the imprecision inherent in internal ratings-based systems. However, the precise level of the leverage requirement should be open for discussion. Institutions that comply with Basel II, and possibly institutions that comply with a more risk-sensitive Basel Ia, may not achieve the full benefits of more risk-sensitive capital requirements because they may push up against the leverage ratio requirement. In order to avoid this result, absent changes to the ratio, these institutions may make balance sheet adjustments based solely on capital requirements rather than on the best interests of the business. Also, we are concerned that these institutions might look to move assets off the balance sheet as a way to avoid capital requirements. These would not be good outcomes. Therefore, it may be necessary to revise the level of the leverage ratio or the manner in which it is calculated.

Competitive Concerns

In the years since the adoption of the Basel I Accord, the ability of all financial institutions to measure risk more accurately has improved exponentially. That ability to measure credit, interest rate, operations, market and other risks is the basis for the changes that will be part of the revised capital requirements. Unfortunately, the complexity and cost of development, implementation and supervision of the models needed to measure and evaluate the risks likely will preclude all but a small number of banks in the United States from taking advantage of the more risk sensitive capital regime proposed in Basel II.

Capital requirements should treat similar risks comparably from institution to institution to avoid creating competitive inequities, and must maintain adequate capital cushions. Last spring, the banking regulators reported that the most recent quantitative impact study conducted to measure Basel II's impact in the United States showed evidence of significantly large reductions in the aggregate minimum required capital for participants in the study and significant dispersion of results across institutions and portfolio types. The results show that capital requirements for mortgage loans could drop by more than 70 percent for some organizations. There are steep drops for home equity loans and other consumer lending products as well. These results have forced the banking agencies to do additional analysis of the study and delay publishing a notice of proposed rulemaking to implement Basel II.

The U.S. study confirmed the results of prior global impact studies performed by the Basel Committee on Banking Supervision that showed the new accord resulting in significant capital savings for some of the largest banks and savings associations in the United States and other countries. These large institutions compete head-to-head with community banks in the retail area, including my bank. Retail lending, particularly residential mortgage lending, is a fundamental business of community banks.

The Federal Reserve Board has released the results of separate studies on the competitive impact of Basel II on small and medium-size business loans and mortgage loans. It also studied the impact Basel II could have on consolidation of the industry. While the studies are well intentioned, we do not necessarily agree with their conclusions. Any studies of this type are often conducted with a lack of perfect data and the need to employ assumptions that may or may not be correct. We also believe that these studies were premised on the assumption that Basel II would primarily affect distribution of capital among large institutions, but would not have material effects on overall capital in the system. The results of the quantitative impact studies show demonstrably that this is not the case. The fact is that no one can really know with certainty what the competitive impact of a bifurcated system will be at this point in time.

The best available evidence suggests that Basel II will open the door to competitive inequities. Under a bifurcated system, two different banks, a larger Basel II bank and a small Basel I community bank, could review the same mortgage loan application that presents the same level of credit risk. However, the larger bank would have to hold significantly less capital than the small bank if it makes that loan, even though the loan would be no more or less risky than if the community bank made the loan. Because we believe that capital requirements play a part in the pricing of loan products, that community bank may not be able to offer the same competitive interest rate offered by the larger institution. This cannot be the right result or the desired result. Capital requirements should be a function of risk taken, and if two banks have very similar loans, they should have a very similar required capital charge. Although some community banks may choose to have capital levels higher than required by regulation, that is a choice that might be made for various legitimate business reasons, and is not a justification for leaving in place higher capital requirements for the same types of lending.

We are concerned that unless Basel I is revised, smaller institutions under a bifurcated capital regime will become takeover targets for institutions that can deploy capital more efficiently under Basel II. For instance, if I could acquire another bank's assets at a fraction of the required capital ratio imposed on that bank, I would surely do so. The required capital at the acquired bank now would be excess capital under a Basel II structure. The bifurcated capital structure would drive acquisitions that otherwise would have no economic purpose. Another important factor for publicly held community banks is the need for them to leverage their capital to maintain a sufficiently high return on assets for their shareholders in order for them to remain independent. And unless Basel I is revised, the smaller banks that survive as stand-alone entities will find it more costly to compete for quality assets and may be forced to operate with higher risk assets in order to provide competitive pricing.

Community banks must retain the option to leverage their capital, regardless of the complexity of the calculations, to improve their ability to manage risk. They must be given the choice to opt in to Basel II or comply with a revised, more risk-sensitive Basel Ia to compete against the international banking giants. ACB is pleased that the bank regulators appear to agree and have committed to revising Basel I to be effective along the same timeframe as implementation of Basel II.

Creation of Basel Ia

As I explained above, the bank regulators have committed to reviewing Basel I and issuing an

Advance Notice of Proposed Rulemaking addressing possible changes to the framework (creation of a Basel Ia) as early as next month. For the reasons stated in this testimony, ACB strongly believes that Basel I must be revised to have more risk sensitive options at the same time as Basel II moves forward. This is essential if the United States is to maintain similar capital requirements for similar risks and not disadvantage the thousands of community banks not eligible to participate in the new capital plan.

ACB believes that any financial institution that has the resources should be able to voluntarily comply with Basel II if its management and the Board believe it is in the institution's best interests. There should not be any constraints on which institutions have the choice to opt in. However, for those institutions without the significant resources needed to meet the very stringent qualification requirements, an opportunity to have alternative, more risk-sensitive capital requirements should be available.

ACB has advocated in its letters to the banking regulators and in previous testimony before this Subcommittee that the current capital regime which is based on Basel I should be amended to take advantage of the ability of institutions and supervisors to measure risk more accurately. The purpose of these changes would be to alleviate some of the disadvantages for community banks that ACB and others believe will develop with the implementation of Basel II for the largest banks.

The current system requires banks to carry far more capital than they need, because it fails to consider such factors as the loan-to-value ratio of retained mortgage portfolios, collateralization of commercial loans, and banks' significant nonfinancial assets. These are examples of elements of risk measurement that will be available to the banks that comply with Basel II, while the vast majority of US banks will have to comply with the current crude risk measurement, unless Basel I is amended. Currently, a mortgage loan with a 20 percent loan-to-value ratio is risk weighted the same as a mortgage loan with a 90 percent loan-to-value ratio. It is clear that the risk is not the same. A revised Basel Ia could include more baskets and a breakdown of particular assets into multiple baskets to take into consideration collateral values, loan-to-value ratios, and credit scores. Credit mitigation measures, such as mortgage insurance and guarantees, could be incorporated into the framework and other revisions could be made to further refine current capital requirements. Such an approach would be relatively simple for banks to implement and for regulators to supervise.

Bank regulators could also adopt a simplified risk-modeling approach that is consistent with the less complex operations of most community banks. The modeling approach would establish capital levels that more clearly reflect each institution's actual risk levels without adding the significant costs of implementation required of the more sophisticated approaches in Basel II. A simplified modeling approach could be developed by the regulators for use by the industry, much like the Office of Thrift Supervision has developed interest rate risk models that are now used by savings associations. It also is likely that third party products and services would become available to assist institutions in adopting a simplified internal ratings system, subject to regulatory review.

We also believe that the smallest of community banks should have the option of continuing to comply with Basel I as it is currently constituted. There are many smaller institutions that hold capital in excess of minimum requirements and will continue to do so after Basel II is implemented. These institutions often operate in small communities and do not face the same type of competition from the larger Basel II banks that is faced by community banks in more urban and suburban areas. These smaller institutions should not have to deal with the increased regulatory burden of changed capital requirements if they would prefer to remain compliant with a less risk-sensitive Basel I.

The bank regulators have listened to our comments and suggestions and are moving forward to improve Basel I. ACB will continue to be actively engaged in this process and is willing to assist the regulators in any way we can to develop a reasonable approach.

Conclusion

In conclusion, ACB does not oppose the implementation of Basel II in the United States but we believe that more examination is needed into the ability to implement the proposal adequately and the competitive impact of a bifurcated capital system. Revisions to Basel I must be made to recognize the lower level of risk of retail loan products (particularly mortgage loans), more accurately reflect the true risks in community bank portfolios, and lessen the unintended competitive impact of Basel II. In order for this to happen, U.S. regulators should make no commitments to their European counterparts during their upcoming meetings on Basel II.

I wish to thank Chairman Bachus, Ranking Member Sanders and the rest of the Subcommittee members in giving ACB this opportunity to present our views. As I mentioned at the outset, there is no more important issue to community banks than the development and implementation of Basel II, as well as long overdue changes in Basel I requirements.