BASEL II: CAPITAL CHANGES IN THE U.S. BANKING SYSTEM AND THE RESULTS OF THE IMPACT STUDY

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

AND THE

SUBCOMMITTEE ON
DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE AND TECHNOLOGY

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

MAY 11, 2005

Printed for the use of the Committee on Financial Services

Serial No. 109–27

U.S. GOVERNMENT PRINTING OFFICE

25–388 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

MICHAEL G. OXLEY, Ohio, *Chairman*

JAMES A. LEACH, Iowa
RICHARD H. BAKER, Louisiana
DEBORAH PRYCE, Ohio
SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
ROBERT W. NEY, Ohio
SUE W. KELLY, New York, *Vice Chair*
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
JIM RYUN, Kansas
STEVEN C. LATOURETTE, Ohio
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
JUDY BIGGERT, Illinois
CHRISTOPHER SHAYS, Connecticut
VITO FOSSELLA, New York
GARY G. MILLER, California
PATRICK J. TIBERI, Ohio
MARK R. KENNEDY, Minnesota
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
KATHERINE HARRIS, Florida
RICK RENZI, Arizona
JIM GERLACH, Pennsylvania
STEVAN PEARCE, New Mexico
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
MICHAEL G. FITZPATRICK, Pennsylvania
GEOFF DAVIS, Kentucky
PATRICK T. MCHENRY, North Carolina

BARNEY FRANK, Massachusetts
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
BARBARA LEE, California
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
JOSEPH CROWLEY, New York
WM. LACY CLAY, Missouri
STEVE ISRAEL, New York
CAROLYN MCCARTHY, New York
JOE BACA, California
JIM MATHESON, Utah
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
ARTUR DAVIS, Alabama
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
DEBBIE WASSERMAN SCHULTZ, Florida
GWEN MOORE, Wisconsin,

BERNARD SANDERS, Vermont

Robert U. Foster, III, *Staff Director*

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

SPENCER BACHUS, Alabama, *Chairman*

WALTER B. JONES, JR., North Carolina, *Vice Chairman*
RICHARD H. BAKER, Louisiana
MICHAEL N. CASTLE, Delaware
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
SUE W. KELLY, New York
RON PAUL, Texas
PAUL E. GILLMOR, Ohio
JIM RYUN, Kansas
STEVEN C. LATOURETTE, Ohio
JUDY BIGGERT, Illinois
VITO FOSSELLA, New York
GARY G. MILLER, California
PATRICK J. TIBERI, Ohio
TOM FEENEY, Florida
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
GINNY BROWN-WAITE, Florida
J. GRESHAM BARRETT, South Carolina
RICK RENZI, Arizona
STEVAN PEARCE, New Mexico
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
PATRICK T. MCHENRY, North Carolina
MICHAEL G. OXLEY, Ohio

BERNARD SANDERS, Vermont
CAROLYN B. MALONEY, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
LUIS V. GUTIERREZ, Illinois
DENNIS MOORE, Kansas
PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
DARLENE HOOLEY, Oregon
JULIA CARSON, Indiana
HAROLD E. FORD, JR., Tennessee
RUBÉN HINOJOSA, Texas
JOSEPH CROWLEY, New York
STEVE ISRAEL, New York
CAROLYN MCCARTHY, New York
JOE BACA, California
AL GREEN, Texas
GWEN MOORE, Wisconsin
WM. LACY CLAY, Missouri
JIM MATHESON, Utah
BARNEY FRANK, Massachusetts

SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE AND TECHNOLOGY

DEBORAH PRYCE, Ohio, *Chair*

JUDY BIGGERT, Illinois, *Vice Chair*
JAMES A. LEACH, Iowa
MICHAEL N. CASTLE, Delaware
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
STEVEN C. LATOURETTE, Ohio
DONALD A. MANZULLO, Illinois
MARK R. KENNEDY, Minnesota
KATHERINE HARRIS, Florida
JIM GERLACH, Pennsylvania
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
PATRICK T. MCHENRY, North Carolina
MICHAEL G. OXLEY, Ohio

CAROLYN B. MALONEY, New York
BERNARD SANDERS, Vermont
MELVIN L. WATT, North Carolina
MAXINE WATERS, California
BARBARA LEE, California
PAUL E. KANJORSKI, Pennsylvania
BRAD SHERMAN, California
LUIS V. GUTIERREZ, Illinois
MELISSA L. BEAN, Illinois
DEBBIE WASSERMAN SCHULTZ, Florida
GWEN MOORE, Wisconsin
JOSEPH CROWLEY, New York
BARNEY FRANK, Massachusetts

CONTENTS

	Page
Hearing held on:	
May 11, 2005	1
Appendix:	
May 11, 2005	45

WITNESSES

WEDNESDAY, MAY 11, 2005

Bies, Hon. Susan Schmidt, Governor, U.S. Federal Reserve Board of Governors	9
Curry, Hon. Thomas J., Director, Federal Deposit Insurance Corporation	15
Follain, James R., Senior Vice President of Mortgage Valuation, Fidelity Hansen Quality	34
Riccobono, Richard M., Acting Director, Office of Thrift Supervision	11
Small, William J., Chairman and CEO, First Federal Bank, Representing America's Community Bankers	33
Williams, Julie, Acting Director, Office of the Comptroller of the Currency	13

APPENDIX

Prepared statements:	
Oxley, Hon. Michael G.	46
Bachus, Hon. Spencer	48
Bies, Hon. Susan Schmidt	52
Calem, Paul S. and Follain, James R.	63
Curry, Hon. Thomas J.	103
Petrou, Karen Shaw	130
Riccobono, Richard M.	147
Small, William J.	166
Williams, Julie	173

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Bachus, Hon. Spencer:	
Additional questions for the record for Karen Shaw Petrou	193
Conference of State Bank Supervisors, prepared statement	194
"In Focus: Stress Shows At Fed with Basel II Drive Sputtering" article from American Banker, August 29, 2005	198
Barnett Sivon & Natter, prepared statement	202
Independent Community Bankers of America, prepared statement	212
National Association of Realtors, prepared statement	223
The Real Estate Roundtable, prepared statement	220
Petrou, Karen Shaw:	
Response to questions from Hon. Spencer Bachus	228

BASEL II: CAPITAL CHANGES IN THE U.S. BANKING SYSTEM AND THE RESULTS OF THE IMPACT STUDY

Wednesday, May 11, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
JOINT WITH THE
SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE, AND TECHNOLOGY
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:04 a.m., in Room 2120, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the subcommittee] presiding.

Present: Bachus, Oxley, Leach, Pryce, Gillmor, Biggert, Kennedy, Feeney, Hensarling, Pearce, Neugebauer, Price, McHenry, Frank, Maloney, Lee, Moore of Kansas, Ford, Baca, Matheson, Green, and Wasserman Schultz.

Mr. BACHUS. [Presiding.] Today, the Subcommittees on Financial Institutions and Consumer Credit and Domestic and International Monetary Policy are meeting to examine the proposed Basel II capital accord and its potential effects on the domestic and international banking systems, as well as on the recently completed fourth Qualitative Impact Study, QIS-4.

I expect that Chairman Pryce will be here in about 20 minutes. She will submit a statement for the record. I appreciate her participation in this hearing.

Today's hearing is the fourth one that the Financial Services Committee has held on Basel II proposals since the 106th Congress. Prior hearings have highlighted disagreements among the Federal financial regulators, as well as substantive problems.

During the last Congress in response to concerns about the Basel process, I, along with Congresswoman Maloney, Chairman Oxley, and Ranking Member Frank, introduced H.R. 2043, the United States Financial Policy Committee for Fair Capital Standards Act. The legislation, which passed out of the committee I serve as chairman by unanimous vote, mandated that the Federal banking regulators develop a unified U.S. position among the agencies prior to entering into negotiations in the Basel committee.

In March, Congressman Maloney and I introduced the same legislation, H.R. 1226, with 36 cosponsors. Let me start by applauding the bank regulators for delaying the notice for proposed rulemaking

to implement Basel II in response to the results of QIS-4. I have been concerned that the regulators have been overly committed to an arbitrary timeline and have been making decisions that fit into their schedule without fully understanding the consequences.

Many banks that may choose to adopt voluntarily Basel II have expressed concerns about being forced to make significant investments without having the full knowledge of the impact Basel II may have on their operations. As I said before, I am encouraged that the regulators have recognized some of these problems with Basel II and hope that common sense will continue to prevail, even if it means delaying the implementation of Basel II beyond the January 1, 2008 deadline.

The goal of Basel II is to develop a more flexible and forward-looking capital adequacy framework that better reflects the risk facing banks and encourages them to make ongoing improvements to their risk assessment capabilities. Over the past 6 years, the United States Federal banking regulators have engaged in negotiations with their foreign counterparts on possible improvements to the standards that govern the capital that depository institutions must hold against their assets.

The Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision participated in those negotiations on behalf of the U.S. Their representatives will be testifying on our first panel. It is expected that when ultimately implemented, Basel II will apply mainly to the largest, most internationally active banks and others that voluntarily adopt it. The remaining institutions in the United States will continue to operate under the original Basel accord, or Basel I.

A growing international consensus has developed that Basel I is outdated and represents a one-size-fits-all approach to regulation, causing some banks to hold too much capital and thus diverting capital from productive lending activities. Additionally, the Basel accord has been criticized for worsening credit crunches, creating incentives for banks to undertake destabilizing short-term lending in emerging markets, for not taking into consideration risk mitigation, creating incentives for banks to securitize expensive assets, and for not addressing credit risk transfers through derivatives.

I applaud the intent and objectives of the Basel II agreement to ensure solvency of our banking institutions and protect against substantial losses by creating a more risk-sensitive regulatory capital framework and to create international standards to manage risk better by aligning regulatory capital to economic risk.

Nonetheless, I and other committee members have concerns regarding Basel II for several grounds.

First, we believe it is unnecessarily complex and costly, with inflexible formulas replacing current rules and supervisory examinations. You can see from the formula that we have displayed that it highlights some of that complexity.

Neither the U.S. regulators nor the Basel II committee members nor the banks can estimate the cost of implementing the Basel II due to costs associated with scaling for different size banks and difficulties in assessing which costs would already have been undertaken by the banks in the ordinary course of business.

No U.S. banking regulator nor any member of the Basel committee has indicated whether sufficient resources exist to implement Basel II. The documents and charts in front of you, as I say, illustrate this point. There are 187 publicly available documents related to Basel II weighing 127 pounds. While some ideas included in these documents have evolved, the amount of paper demonstrates the complexity and micromanagement that Basel II represents.

In addition, the chart with all the letters and numbers is the Basel II formula itself. I have no doubt that there are very few people who understand this formula or its implications. It looks like a formula for micromanaging the banking business, rather than one designed to align regulatory and economic capital assessments. In addition, I believe that the current draft would create an uneven playing field, one that unfairly penalizes many banks in the country, particularly our regional banks.

Many believe that Basel II banks will have a significant competitive advantage because they will need to hold less regulatory capital for certain asset classes, for example credit cards, corporate lending, and mortgages, and because mortgage participants will perceive Basel II banks to be better managed than Basel I banks. I am also concerned that bank consolidation could be accelerated solely because of the regulatory capital benefits associated with Basel II implementation.

The uneven playing field would carry over across borders, since the proposal expressly contemplates over 50 opportunities for local regulators to tinker with this formula. What is more, the Basel committee itself has not yet figured out how regulators will communicate and work together with each other to set meaningful regulatory capital requirements for globally active banks that have operations in multiple countries. How one could end up with an international common standard in this situation is difficult to perceive.

Another concern that we have with the proposal is the treatment of operational risk. It is my belief that a supervisory assessment by the regulator, as opposed to a regulatory capital cover, is the better approach to limiting a bank's operational risk.

It is my understanding that the databases are insufficiently robust for banks to provide meaningful input into the QIS process. If so, how can we implement these requirements without knowing how they will impact real banks and real portfolios? How can the regulators have confidence that the systems will be in place by the supposed implementation date? What if the data at that stage generates unexpected answers as they do now, as the credit risk numbers have done for QIS-4? What do we do then?

At today's hearings we will hear from a distinguished panel of regulators, including Federal Reserve Governor Susan Bies, Acting Comptroller of the Currency Julie Williams, FDIC Director Tom J. Curry, and Acting Office of Thrift Supervision Director Richard Riccobono, as well as a panel of private sector witnesses. I look forward to hearing from today's witnesses, and thank them for taking time from their busy schedules to join us.

I am now pleased to recognize the Ranking Member. Actually, in his absence, I am going to recognize the gentlelady from New York, Ms. Maloney.

[The prepared statement of Hon. Spencer Bachus can be found on page 48 in the appendix.]

Mrs. MALONEY. Thank you, Mr. Chairman.

I thank all our witnesses and everyone who is here that is concerned about this issue. This is the fourth hearing that we have called. This is very much of a bipartisan concern. We have had several that have focused on it.

The first Basel Capital Accord established minimum standards for banks that operate internationally. Basel II is an attempt to update this accord by allowing financial institutions to hold capital in a balance more reflective of risk and changing market conditions. From the beginning of the negotiations, I have been concerned, as many of my colleagues have been, that the U.S. regulators need to address these negotiations from a consistent and coordinated viewpoint and to start from the premise that the new standards do not put American financial institutions or any segment of them at a competitive disadvantage.

In the last Congress, we legislated. We held hearings that really called upon U.S. regulators to develop a uniform position before negotiating in the Basel committee. Once implemented, the final capital accord will have profound consequences for the banking industry, our constituents, and the economy of our country. We must take the time and the focus to get this right.

The results of the QIS-4 study I find very disturbing. It shows that some banks adopting the proposed Basel II standards will be able to reduce their regulatory capital considerably and, thus, gain a competitive advantage with other domestic banks that may not be in Basel. More disturbingly, the amount by which a bank might be able to reduce its regulatory capital varied widely among banks that appeared to be very similar, to have similar portfolios, and should, in theory, be treated equally under the new standards.

These results do not support, and indeed actually cut against, the reassurances we have consistently received from the regulators that the new standards have been designed to treat like-risk alike and establish an international level playing field. I am concerned that they also suggest that the complexity of the new standards makes them more prone to widely differing interpretation and results.

The stacks of paper that have been put there by the majority staff, that is the proposal for Basel II. It is very long, and over here is the formula. If you look at the number of variables in this formula on this chart, each of them represents an opportunity for a regulator to tweak the definition of that variable so to put a home bank at an advantage. This, at least, is a formula for confusion.

I am very concerned. I know that our regulators are going to be very tough on American institutions. I am not so convinced that foreign regulators are, in very small countries and in other countries. I am afraid that that might put us at a disadvantage. If the regulators themselves do not understand the reason for the differences that came out in the QIS-4 study, then how can they hope to effectively monitor and supervise compliance? I have not seen any explanation that explains why so many like banks with like portfolios came up with different conclusions.

Former Comptroller Jerry Hawke was highly critical of what he termed "the monumental prescriptiveness" of the Basel II standard. Unfortunately, these widely disparate results demonstrate that his concerns, which I share, appear to have a basis in fact. I hope that we will have this clarified by the witnesses.

I would like to say that why don't we just have a simpler rule, just Basel I plus something that applies uniformly, that would move more banks, and the United States would be able to comply with it? I am very concerned about this highly confusing formula that has many opportunities to be tweaked and interpreted in various ways by various regulators in other countries.

So I thank you for all of your hard work, and I look forward to your testimony.

I yield back.

Mr. BACHUS. Thank you.

At this time, I would recognize the ranking member of the full committee, Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman. I appreciate the diligence with which you have been pursuing this.

I have some questions about the technical aspects of the formula, but I will defer those and submit them in writing in deference to the recorder.

The concern I do have, though, is touched on by the comptroller's testimony and the FDIC's testimony. I have not had a chance to read the OTS testimony yet. But in particular in the testimony in the FDIC, it is especially the concern for the competitive effects. I appreciate Mr. Curry's very straightforward statements that if you go ahead with Basel II and do nothing else, you put smaller banks at a disadvantage.

Now we already have a problem. We are in a controversy now over deposit insurance. This House passed a bill that would increase deposit insurance not by a huge amount, $30,000. The likelihood is that that will not survive in the Senate. I supported it, but it may not survive. That, smaller banks argue, is something of a disadvantage for them. It is a perceptual disadvantage from people who have large deposits to make and think the bigger the bank, the less likely it is to fail, or be allowed to fail; therefore they go toward the bigger banks.

We are, I think, this is not an abstract consideration. Big banks are fine, but big banks to the exclusion of little banks are not so fine. I want to give a little bit of experience here. A few years ago, Mr. Curry would remember, he was there at the time, Fleet and Bank Boston merged. There were at the time a number of overlapping branches. The question was, what do you do with the overlapping branches?

There was a proposal from the antitrust regulators, both State and Federal, that they be packaged together and sold to one large outside bank because that would be more competition for Fleet and Bank Boston. It seems somewhat nostalgic to talk about a large New England bank, doesn't it? But that is where we then were, but that is relevant to the pace at which consolidation is moving and underlies these concerns.

Overwhelmingly, my colleagues in Congress and I heard not from banks, but from borrowers, small borrowers, local Chambers of

Commerce, retailers, homebuilders, people who were in the local markets: Please do not do that; we do not want to have to deal with the very large banks; we want to deal with local banks.

We argued for a divestiture of at least some of those overlapping branches to community banks. We were successful in getting I think about 12 or 15 percent, but not enough. I remember, frankly, the Boston Globe was critical. They said we were shilling for Fleet by preventing a big competitor. A year later, they had an article saying, well, it turns out that there is greater consumer satisfaction with the smaller banks. Big banks have their role and so do smaller banks.

Public policy and the economy and the economies of scale and all these other factors are tending to drive us toward consolidation. In Massachusetts, as former Commissioner Curry knows, the relevant analogous committee to us is called the Committee on Banks and Banking. Someone said, are you ever going to change the name back here to the Committee on Banks? I said no. By that time, we will call it the Committee on the Bank because there will be one in the whole country at the way we are going.

It is not in our interest to accelerate that trend. We have very strong, very explicit testimony from the regulators, particularly those of the smaller banks. The Federal Reserve deals with the bank holding companies, but the FDIC, particularly the smaller banks, and the Comptroller, both of them argue that there is a negative competitive effect. I must tell you, I cannot see any argument for going ahead with adopting a policy that will increase the pressure on smaller banks and increase the competitive advantage that goes to larger banks, with no comparable consumer advantage in this case, by itself.

I know people have said, well, after we do this, then we can do that. Well, that could come before this as well. So I think a heavy burden of proof goes on those who tell us that.

The final thing I would say is this, Mr. Chairman. I note, and Governor Bies, who has been very cooperative and has met with us, and I appreciate the Federal Reserve's willingness to talk with us about this, but maybe it was one of the others; maybe it was Ms. Williams who said: Remember, once we go through with Basel II, we still have to adopt it, the bank regulators.

But I will ask, I may not be able to stick around, but I would hope you would answer, ″Yes, but with what freedom?″ If we are a signatory to Basel II, are we free to disregard it? I mean, it is true that it does not automatically go into effect, you tell me, but it does seem to me that we would be under serious constraints. The likelihood that we could as we adopted it ignore some of the major factors is a problem.

So this conceded competitive disadvantage for smaller banks is a greater obstacle, it seems to me, than any of the advantages. At the very least, it rates a very strong argument that the timing is out of whack and that there is no reason why we should not be able to at least proceed simultaneously. That is, I will take a lot of convincing that we should decrease capital requirements for the larger banks before we do the other.

One last point, if I could, Mr. Chairman. I would just note that there has been some concern expressed in other quarters on a mat-

ter we are going to be dealing with, the Fannie Mae and Freddie Mac, on the danger of them holding mortgages in their own portfolio, rather than securitizing it, on the grounds that this will add to credit risk. I was very pleased when we wrote Governor Bies on this subject because it has something to do with Basel and other things. Here is what she said: "Adopting institutions are likely to hold more mortgages on their balance sheets after Basel II."

This is about Basel II, but it seems to me it has some relevance here. "Since most of the likely increased holdings would come from those that are now being securitized, these additional mortgages would generally be of high quality, as are most residential mortgages that are currently securitized. That is while mortgage portfolios of adopting institutions may be larger and we would not expect a significant increase in the credit risk of bank mortgage portfolios."

In other words, when you are talking about mortgages which are already of sufficient quality to be securitized, whether they are held on the balance sheet of the institution or securitized does not affect credit risk. I guess I will need to be persuaded by the Federal Reserve why what is sauce for the Basel goose is not sauce for the GSE gander.

Thank you, Mr. Chairman.

Mr. BACHUS. Thank you.

I now recognize the chairman of the full committee, Chairman Oxley.

Mr. OXLEY. Thank you, Mr. Chairman.

I first want to associate myself with the excellent remarks of the ranking member from Massachusetts. I want to thank you and Chairwoman Pryce for calling today's hearing on the proposed changes to the Basel accord. You have been a real leader on the issue of Basel II reform, and it is most appreciated.

Significant changes to the proposal have been made in response to your concerns additionally by bringing attention to this process. The committee has seen increased cooperation among U.S. regulators who are developing Basel II. Basel II is critically important to every bank in the United States and the rest of the world, and it will determine how much regulatory capital must be held to cover risk in bank portfolios, domestically and globally.

Capital standards also influence market perceptions of a bank's strength, which directly impacts ratings decisions. I do not think you will find much argument that the Basel accord is outdated and needs revision. This developed in the late 1980s before liquid markets for credit had been developed and before the derivatives and securitization markets had taken off. These developments have made the Basel accord obsolete and prone to abuse.

The most recent impact study conducted by the U.S. regulators, QIS-4, shows major swings in how much regulatory capital banks using this new framework might need to hold. Participants estimated decreases of as much as 40 percent. Others estimated increases of as much as 60 percent from the current standard. Even though no bank came close to breaching the leverage ratio, these kinds of results are unacceptable. No one knows why these results came out the way they did. In other words, no one in the regulatory community seems to know how the new framework will affect retail

credit markets in the United States, particularly credit cards and mortgages.

These market sectors are the backbone of our economy and permit the United States to serve as the sole engine of economic growth among developed economies in the world. I believe it would be irresponsible to proceed quickly under these circumstances, and the regulators were wise to pause before finalizing Basel II. It would be helpful to know how the regulators are progressing with all the various data problems and when we will have a greater understanding of the QIS data.

I would encourage the U.S. regulators to allow time for all the data to be understood before making any international commitments regarding final text and implementation. Regulators also should be discussing how they will cooperate in order to implement the new framework.

Significant changes in Basel II may be needed here and abroad before a final proposal is ready. In the meantime, I believe that U.S. regulators should continue working on updating the Basel accord so that banks in the United States can benefit from the changes in the obsolete framework while regulators try to put together a functional Basel II proposal. It seems that this would be the most equitable way to make improvements to the capital standards.

I am interested in hearing what the witnesses think about this. We welcome the distinguished panel of experts and regulators who have worked tirelessly to implement and to in some cases correct some of the problems that were heretofore mentioned.

I thank the Chair, and I yield back.

[The prepared statement of Hon. Michael G. Oxley can be found on page 46 in the appendix.]

Mr. BACHUS. I thank the chairman.

Are there any other members who wish to make opening statements?

Mr. GILLMOR. Mr. Chairman?

Mr. BACHUS. Mr. Gillmor?

Mr. GILLMOR. Mr. Chairman, I want to take the opportunity to introduce a constituent of mine who will be on the second panel, Bill Small from the Fifth District of Ohio. Bill is the President and the CEO of First Financial, which is based in Defiance, Ohio. Today, he is testifying on behalf of America's Community Bankers, an organization on which he serves as a board member and also on several committees.

Bill Small has also recently served as the President of the Federal Reserve's Thrift Institutions Advisory Council, and he contributes significantly to our community, working with Defiance College, Defiance YMCA, the Rotary Club, and others. I appreciate his service to the district, and I am sure that his comments today will be very helpful to this committee in its deliberations.

Thank you, Mr. Chairman, and I yield back.

Mr. BACHUS. Thank you, Mr. Gillmor.

Hearing no other members that wish to make opening statements, at this time I will introduce the first panel. I am going to go from my left.

Our first panelist is the Honorable Susan Schmidt Bies, Governor of the U.S. Federal Reserve Board of Governors. I want to personally say that since your appointment to head up this at the Fed, that I think our relationship, at least our communications, has improved, so I commend you for that.

Mr. Richard M. Riccobono is Acting Director of the Office of Thrift Supervision.

Ms. Julie Williams is Acting Director of the Office of the Comptroller of the Currency.

And the Honorable Thomas J. Curry is Director of the Federal Deposit Insurance Corporation. I want to commend OTS, the OCC, and the FDIC for your concerns that you have expressed as to the affect that these proposals will have on your member institutions. I very much appreciate the focus you have given this. I think you have been a large reason why we have not rushed into this headlong and made some great errors. So I commend you.

At this time, I recognize Governor Bies. We will start with you for your opening statements. The opening statements, although we say 5 minutes, one or two have mentioned that your opening statement may be 6 or 6 1/2 minutes. We are not going to strictly enforce that 5-minute rule.

STATEMENT OF HON. SUSAN SCHMIDT BIES, GOVERNOR, U.S. FEDERAL RESERVE BOARD OF GOVERNORS

Ms. BIES. Thank you, Mr. Chairman. Good morning Chairman Bachus and Chairman Pryce and members of the Subcommittees.

It is my pleasure to join my colleagues here today to discuss the current status of Basel II in this country. My comments are going to be brief, and I ask that my full statement be placed in the record.

The agencies' joint decision to delay the scheduled mid-year release of the notice of proposed rulemaking for Basel II was prudent and necessary. Our most recent study of the potential quantitative impact of the proposal, QIS-4, suggested much larger than desirable reductions in capital and a surprisingly wide dispersion in the estimates of the risk parameters that are used to determine regulatory capital under the proposal. As responsible regulators, we believe it is appropriate to improve our understanding of these results and to consider what changes might be needed to our proposal before we move forward on the NPR.

However, delaying the NPR and related documents creates a dilemma. Without them, core and potential opt-in banks do not have the blueprints to complete the databases and systems for the regulators to fully assess how banks would operate under Basel II. With limited databases and systems, banks provided us in QIS-4 their best estimates. We need to learn what we can from reviewing their responses, but there are limits to what we can learn as we do this review.

Consequently, we should, as soon as feasible, continue with the development of the NPR and related supervisory guidance. These documents are essential to the ultimate provision to us of the credible inputs we need to evaluate the effects of Basel II. We hope thereafter that we can stay as close as possible to the 2008 start date for the so-called transition run. The ability of banks to do so

is one of the questions we propose to ask in the NPR. If evolving developments require we delay this schedule, we will of course do so and announce it as soon as the decision is made.

As described in some detail in my statement, the implementation process that has been proposed would have banks providing us credible inputs based on real databases and systems over at least a 3-year period. We know banks' evolution in these processes is proceeding very quickly. A lot can be accomplished in this timeframe.

For individual banks, implementation can only occur as soon as supervisors are satisfied with each bank's systems and processes. If a bank does not meet these standards, they will not be allowed to go into Basel II. The delay in the NPR and this implementation schedule are fully consistent with the policy the agencies have followed throughout the development of Basel II. We have made many changes that incorporate comments that we have received and tried to base our decisions based on the best evidence available at the time. We have announced that we would not move to final implementation until we are confident that Basel II was consistent with a safe and sound U.S. banking system.

Basel II is an important supervisory advance. The current framework is being arbitraged aggressively and provides us with less and less reliable measures on which to base a regulatory capital requirement for our largest and most complex banking organizations. Our banking system and financial markets are strong and safe now, but they were not always so in the past two decades. We need now to take the steps to ensure that the current safety and strength is extended for our large global banking organizations.

Members of the subcommittee, the FDIC has underlined the importance of supplementing the risk-based capital requirement of Basel II with a minimum leverage ratio and prompt corrective action as part of a prudent supervisory regime. I want to be quite clear that the Federal Reserve concurs in the FDIC's view. We need for reasons I have described the risk measurement and risk management infrastructure and risk sensitivity of Basel II, but experience suggests that we also need the supplementary assurance of a minimum equity to asset base for entities that face the moral hazard of the safety net.

All of us are aware of the concern of thousands of banking organizations that will not be subject to Basel II that they will be placed at a competitive disadvantage. The results of QIS-4 have only heightened these concerns. The Federal Reserve's research published in our competitive studies has identified competitive impacts in the small business and residential mortgage markets. The agencies are as a result developing simple modifications to the current rules that will make them more risk sensitive to address these competitive concerns.

We hope to publish a proposal to amend Basel I for those banks that will not be in Basel II at the same time that the Basel II NPR is released. In this way, the public can review both proposals, compare them, and give us comments on each, particularly around the competitive impacts. Let me make clear that these modifications would in no way make such revised current rules substitutes for the needed reforms for the sophisticated financial products and

services provided by our large complex internationally active organizations.

I will be pleased to answer any questions. Thank you.

[The prepared statement of Hon. Susan Schmidt Bies can be found on page 52 in the appendix.]

Mr. BACHUS. Thank you.

Now, Director Riccobono.

STATEMENT OF RICHARD M. RICCOBONO, ACTING DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. RICCOBONO. Good morning, Chairman Bachus, Chairman Pryce, Chairman Oxley, and Ranking Member Maloney. I want to first thank you for holding this hearing on Basel II and for your continued interest in this issue. I would ask Chairman Bachus if I could submit my written testimony into the record.

I particularly want to thank you, Chairman Bachus, for your legislative efforts in H.R. 1226. We fully support it, including the provision you have in there regarding OTS's representation on the Basel committee. It is important that OTS's international role be formalized for numerous reasons, not the least of which is the potential impact of Basel II on the institutions and holding companies we regulate.

OTS is experienced in regulating institutions that specialize in residential mortgage-related lending, now representing almost 40 percent of the assets of the entire U.S. banking system. It provides us with a unique supervisory perspective. In addition, our experience regulated diverse holding company structures recently recognized by the European Commission when it quoted OTS equivalent under the EU's financial conglomerates directive as another important reason for OTS's representation on the committee. Although we are more than 2 years from its projected implementation, now is a good time to update you on our progress and the issues that U.S. institutions may face under Basel II.

We very much support Basel II and are committed to implementing a prudent and sensible framework for it in the U.S., but there is much to be done before we are ready to implement it. While Basel II provides an opportunity for our largest U.S. institutions to move to a more logical risk-based capital framework, it is equally important to identify ways to improve the risk sensitivity of Basel I for the thousands of institutions that will remain subject to it. These objectives are not mutually exclusive, but rather mutually dependent in order to prevent potential competitive inequalities between Basel II adopters and non-adopters.

Risk-sensitive capital requirements are as important for community banks as they are for large internationally active institutions. Achieving greater risk sensitivity for one part of the banking system and not the whole will create competitive distortions. While global regulatory convergence of capital standards is extremely important, we must not ignore its effects and potential impact on U.S.-based institutions that are not operating internationally.

OTS is pleased that an initiative we advocated for years, the so-called "Basel I rewrite," has ripened into a commitment by all the Federal banking agencies to modify Basel I for U.S. institutions not adopting Basel II. The goal of this initiative is to achieve greater

risk sensitivity without undue complexity. This can be accomplished by applying more accurate risk weights for a wider range of asset buckets and by applying commonly understood criteria for assessing the relative risk of various loan types. We strongly support amending Basel I in conjunction with Basel II, but sooner if Basel II timeframes are pushed back.

On the issue of timing, the results of QIS-4 suggest that Basel II is very much a work in progress in the U.S. It is appropriate at this juncture to ask whether we may be moving too quickly, and if so to reassess and determine how to adjust existing timeframes. Although implementing a more risk-sensitive capital framework is an important objective, we must do so mindful of an equally important objective of doing no harm to our existing banking system.

Given what we have learned so far from QIS-4, prudential supervision suggests that a longer implementation period may be needed to gain the necessary data and confidence we require before implementing such a major change to our capital framework. We believe as a matter of good public policy that the Basel II timeframes should be viewed as guidelines, not hard targets.

QIS-4 also did not capture the impact of interest rate risk largely because Basel II treats interest rate risk differently than other risks. As noted earlier, the banking and thrift industries currently have almost 40 percent of their assets in residential mortgages and mortgage-related assets. Interest rate risk, especially important for mortgage products, must be addressed uniformly with guidance from the Federal banking agencies on how to measure and manage this risk.

Any discussion of Basel II is incomplete without a discussion of the interrelationship between leveraged and risk-based requirements. Unfortunately, the issue has spawned a substantial amount of dialogue about whether there should be a leverage requirement at all. OTS does not advocate eliminating a leverage requirement. I am going to say that again. OTS does not advocate eliminating a leverage requirement.

However, the current one-size-fits-all approach to a leverage ratio runs at cross-purposes with Basel II. Leverage treats all assets on the balance sheet identically. It provides too little incentive to manage risk for both very low and very high credit-risk institutions, and off-balance sheet activity is untouched by existing leverage requirements. Moreover, a capital framework with a risk-insensitive leverage ratio may have the unintended consequence of perversely motivating low credit-risk lenders to pursue riskier lending.

Likewise, layering in a variety of permanent countermeasures such as arbitrary floors and multipliers into Basel II to offset capital reductions in low credit-risk portfolios undermines the overarching goal of creating a more risk-sensitive framework. It is critical that we address the leverage requirement and the Basel II floors as a complete seamless and integrated time framework.

We will continue to work with you, the other Federal banking agencies, and our colleagues in the international community to ensure that we do not sacrifice safety and soundness for the sake of delivering a timely, but potentially flawed capital framework.

I will be happy to answer any questions that the committees may have. Thank you.

[The prepared statement of Richard M. Riccobono can be found on page 147 in the appendix.]

Mr. BACHUS. Thank you.

Acting Director Williams?

We appreciate your testimony, Acting Director Riccobono.

STATEMENT OF JULIE WILLIAMS, ACTING DIRECTOR, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Ms. WILLIAMS. Chairman Bachus, Chairwoman Pryce, Congresswoman Maloney, members of the Subcommittees, thank you for inviting the Office of the Comptroller of the Currency to participate in this very timely hearing.

In my remarks this morning, I will highlight three areas: first, where we stand on implementation of the Basel II framework in light of the recent results of the fourth quantitative impact study, QIS-4; second, our commitment to contemporaneously modernize the current domestic capital rules for those banks that will not be governed by the Basel II rules; and finally, some thoughts on H.R. 1226.

Last year, the U.S. banking agencies undertook a fourth quantitative impact study, QIS-4, with the specific goal of gaining a better understanding—before its adoption—of how Basel II might affect minimum risk-based capital within the U.S. banking industry. The agencies recently completed a preliminary analysis of the QIS-4 data and certain initial observations became very evident to us.

In brief, the QIS-4 data evidenced both a material reduction in the aggregate minimum required capital for QIS-4 participants and a significant dispersion of results across institutions and across loan portfolio types. For example, aggregating over the QIS-4 participants, the decrease in effective minimum required capital was 17 percent, while the median decrease among participants was 26 percent. Changes in effective minimum required capital for individual institutions ranged from a decrease of 47 percent to an increase of 56 percent. While some dispersion of results in a truly more risk-sensitive framework is to be expected, we are not convinced that the wide ranges indicated by QIS-4 can be fully explained by the relative differences in risk among institutions.

I must pause here to strongly emphasize that the change in what we are calling effective minimum required capital represents the change in capital required to meet an 8 percent minimum total risk-based ratio. It does not reflect that individual institutions in fact hold capital in excess of regulatory minimums and, therefore, it does not imply that any particular institution would actually need to increase its capital in order to be capital—compliant.

Finally, changes in minimum capital requirements—both increases and decreases—of certain portfolio types, credit cards on the one hand and mortgages on the other, significantly exceeded our expectations.

Based on this preliminary assessment of QIS-4 results, the agencies concluded that a delay in the notice of proposed rulemaking was the only responsible course of action available to us. For that reason on April 29th, we announced that we would not publish a proposed rule on the schedule that we had previously forecast.

The obvious question all this raises is, what now? We continue to believe in the potential of Basel II to achieve its crucial objectives: improved risk management, supported by significantly greater risk sensitivity in the regulatory capital framework. But, the issues surfaced during our preliminary work point to a need to do a more complete assessment of the QIS-4 results. This additional work is necessary to determine whether the preliminary results reflect actual differences in risk, simply reveal limitations in QIS-4, are the product of variations in the stages of bank implementation efforts, and/or suggest the need for adjustments to the Basel II framework.

The results of our additional work will tell us much about the steps that we need to be taking in order to make Basel II a reality for U.S. financial institutions. If we believe that changes in the Basel II framework are necessary, we have consistently said that we will seek to have those changes made by the Basel Committee.

I also want to assure you that the U.S. banking agencies recognize that domestic institutions not subject to Basel II-based capital requirements, including mid-sized and community banks, have a strong interest in the ways in which their products, pricing, and business strategies might be affected by implementation of Basel II by their competitors. That is why we have undertaken a separate, but related, effort to update and modernize the domestic risk-based capital rules for those institutions not subject to Basel II. The agencies are developing these two capital rulemaking projects in tandem to ensure that appropriate risk sensitivity and consideration of competitive effects are considered in each proposal.

Finally, the Subcommittees have asked for our views on H.R. 1226. We share the desire of the bill's sponsors to ensure a strong and consistent position among the banking agencies in our approach to Basel II. We also agree that the types of factors listed in the bill are very relevant to evaluating the impact of implementing Basel II. However, with the greatest respect, we do not believe that legislation is needed to achieve these results. Since the beginning of the process that led to the adoption of the Basel II framework, the agencies have worked closely together. While there have been differences in views along the way, I believe these different perspectives have, on balance, been constructive. I have confidence that this will continue to be the case.

Also very relevant here is the fact that the OCC, and I believe also the OTS, has designated the Basel II rulemaking as a significant regulatory action for purposes of Executive Order 12866, which requires us to prepare a regulatory impact analysis (RIA) for OMB review prior to publication of the proposal. The RIA will include an assessment of the costs and benefits of the proposed regulation, and it will address many of the factors that are identified in H.R. 1226.

In closing, let me emphasize three commitments that have been and that remain central to our work on the Basel II framework: first, an open rulemaking process in which comments are invited and considered, good suggestions are heeded, and legitimate concerns are addressed—there is no done deal here; second, a reliable quantitative analysis prior to adoption of a rule, through which we can assess the likely impact of Basel II on the minimum regulatory

capital requirements of our banks; and finally, a prudent implementation in which we make well reasoned and well understood changes to bank capital requirements and incorporate those changes with appropriate conservatism.

Thank you for holding this important hearing, and I look forward to answering your questions.

[The prepared statement of Julie Williams can be found on page 173 in the appendix.]

Mr. BACHUS. Thank you.

Mr. Curry?

STATEMENT OF THOMAS J. CURRY, DIRECTOR, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. CURRY. Thank you, Chairmen Bachus and Pryce, and Ranking Member Maloney and members of the subcommittees. I am pleased to represent the FDIC at this important hearing.

Basel II is an effort to tie capital requirements more closely to risk and promote a disciplined approach to risk management at our largest banks. The FDIC supports these goals and the process of implementing a revised capital framework in the United States.

First, I would like to mention some concerns the FDIC has about the results of the recent quantitative impact study, or QIS-4. The issues we discuss today may sound sweeping and fundamental, but we believe that they can be resolved. Our intention is to work with our fellow regulators to address our concerns and to move forward expeditiously when this is done.

The agencies's review of QIS-4 is not complete. Nevertheless, in part because the QIS-4 results are consistent with previous FDIC analysis, we have formed some preliminary conclusions. In our view, QIS-4 shows excessive reductions in risk-based capital requirements. For half of the 26 banks in the impact study, capital requirements fell by more than 26 percent. This is without fully factoring in the benefits of credit risk hedging and guarantees that are likely to reduce capital requirements significantly more.

For individual loan types at individual banks, almost half the reductions in capital requirements were in the range of 50 percent to 100 percent. Numbers like this do not give us comfort that the Basel framework will require capital adequate for the risks of individual activities.

We are also concerned about what the dispersion of results suggests about the difficulty of applying the framework consistently across banks. Capital requirements in Basel II are very sensitive to inputs. Achieving consistency in Basel II depends on the idea that best practices and best data will lead to convergence in the capital treatment of similar loan portfolios across banks. At present, however, at least as indicated by QIS-4, there is little commonality in the approaches the various banks used to estimate their risk inputs.

The FDIC has stated on many occasions that there is a continued need for a leverage ratio. I would add at this point that the QIS-4 results suggest to us that our U.S. leverage requirements will be even more important under Basel II. The FDIC can support moving forward with this new framework only because of the existence of the leverage-based component of U.S. capital regulation.

We also have a concern about the potential competitive effects of the new framework. If QIS-4 is representative of capital requirements going forward under Basel II, the competitive ramifications for community banks and large non-adopting banks could, in our view, be profound. If Basel II is implemented unchanged, the only option for mitigating these competitive inequities would appear to be a substantial reduction in capital requirements for all insured institutions.

All of these issues suggest to us that thought needs to be given to finding ways to implement this new framework in a manner that produces results that are less extreme and more consistently applicable across banks.

With respect to the issue of capital requirements for operational risk, I will make one point. Because Basel II's advance measurement approach, or AMA, is complex and expensive, large banking organizations understandably do not want to implement it at each and every insured subsidiary. The FDIC believes, however, that every insured institution should maintain an adequate level of capital, a point of view that, strictly speaking, implies the need for every insured bank to have its own AMA.

In resolving these conflicting goals, we are inclined to seek ways of moderating the AMA, rather than compromising the important responsibilities of insured banks and their boards. For that reason, we will continue to work with our fellow regulators to explore simpler, less burdensome approaches for insured institutions to meet their requirements for operational risk within this new framework.

In summary, for Basel II to be successful the FDIC believes we must preserve a set of straightforward minimum capital requirements to complement Basel II, maintain competitive equity among large and small domestic and international institutions, and find ways to achieve results under Basel II that are less extreme and more consistently applicable across banks.

The FDIC, in cooperation with the other banking agencies, will proceed in an appropriately deliberative manner and with full consideration of the comments of all interested parties. We believe these goals can be achieved.

This concludes my remarks. I will be happy to answer any questions from the committee.

[The prepared statement of Hon. Thomas J. Curry can be found on page 103 in the appendix.]

Mr. BACHUS. Thank you.

Governor Bies, let me ask you the first question. I want to go back to one reason that we are having the hearing today, and that is an article I read back in January in the American Banker. What it said there, it referred to a study that the Fed had done. This study says that residential mortgage portfolio capital levels will drop so significantly at the 20 or so U.S. banks that adopt Basel II, that they will hold a major competitive advantage over all other U.S. banks.

Now we know that that paper was never published. It was prepared by two economists, one of which had worked for the Fed for 20 years, who no longer works there. They are on our second panel. When I read that, it was everything that the other regulators had been saying. It was everything that regional banks and others had

been saying to us, but it was counter to what the Fed's position was. It was counter to what Mr. Ferguson was saying. So I immediately wondered why the paper was never published, because I am very concerned about people being able to speak out without any fear of expressing a different opinion from someone else.

Since that time, I have read that even one of the Governors of the Federal Reserve in St. Louis expressed the same concerns and said that he believed that there was a good chance there would be a competitive advantage, a major competitive advantage for the large banks. There have been others that have expressed this opinion, including other regulators.

And then you all took another look at it. You did not publish the first report. It never was published by the Fed. And now you have come out with a second report which basically appears to be the opposite of the first report, that says Basel II will not tilt the mortgage field.

Can you give me some background on maybe why, number one, the Fed decided not to publish that paper? Number two, I know the two gentlemen have left, and I assume, I am sure they left voluntarily, but why would economists that had been there 20 years come up with one conclusion, and then you get another group of economists at the Fed and they come up with a different conclusion? Did the second report maybe conclude some things starting out that the first one did not?

Ms. BIES. Mr. Chairman, I think you know that if you get in a room with several economists, you will get very different perspectives. We even get it when we talk about where interest rates may go. The one criterion that the Fed sets for all the research is the quality of the research. As the paper was initially completed, there were some concerns about the qualitative aspects of the research itself, not the conclusion.

I want to make it clear that we encourage information at the Fed because of the ability to really understand factually what is happening. It is something we rely on whether we are dealing with monetary policy, bank supervision, or consumer affairs. We look at it all, but we want strong research. We encourage it not only at the Board, but each of the Federal Reserve banks. That is why we allow the Federal Reserve banks to have their own opinions. The only standard we ask is quality research.

Mr. BACHUS. Let me say this, I am not saying that that is why they left. I have no reason to believe that. I am just saying that they concluded one thing and then your next study another, and they were experienced economists, well respected. And then a different group of economist at the Fed concluded a diametrically different conclusion. Doesn't that bother you or disturb you that your own economists cannot even agree, that some of your economist have said, some that have been there 20 years in fact?

I guess it was the two that the Federal Reserve asked to do this report. That would lead me to believe you felt maybe, or someone at the Fed felt they were the most qualified at the Fed to do it. They did it and concluded that it would be a major, major competitive advantage for the 20 largest internationally active banks over all our other banks. We are talking about residential mortgages here, which could have a tremendous impact on every American

who has a mortgage or wishes to buy a home. And then that was not published. Why wasn't it published?

Ms. BIES. Let me get to the bottom line of the conclusions of the research.

Mr. BACHUS. Sure.

Ms. BIES. I think here what we need to understand is what the questions were that were being asked. When we talk about the impact on most mortgages in the United States, most of those mortgages are securitized today. They are underwritten for credit based on Fannie and Freddie standards.

Mr. BACHUS. But you know, there are proposals to change that, as Mr. Frank I think mentioned. So you are assuming that things are going to go on as they are at the GSEs when there is major legislation up here that could change that?

Ms. BIES. I guess I want to make a distinction there. I am talking about the securitization of the mortgages, not whether Fannie and Freddie choose to buy back those mortgages that have been securitized. That is a separate issue.

Mr. BACHUS. But if we put a cap on their capital, which the Treasury for one is proposing that we do that, that would affect whether they bought the——

Ms. BIES. Right. But to the extent they have to fund it all, it still would influence rates in a similar way, and that is a separate issue.

I am trying to get at the results of this research. To the extent that the loans are still going to be securitized, the loans that are being securitized on the standard mortgages are priced in markets today. There will be little impact of that on financial institutions. The real differentiation is going to be the choice that institutions make to hold whole loans on their books or to hold mortgages that are not conforming on their books.

As you are well aware in the last couple of years, as the housing industry has had strong price appreciation, consumers have refinanced, and we have seen evolving structures of various types of mortgages. Some of these are riskier than traditional mortgages. Others are just as safe. They are just bigger than conforming loan sizes are. For the portfolio loans, the loans institutions would like to hold on their books, we do need to make changes to Basel I or we would end up with an imbalance because the 1988 Accord overestimated the kind of capital you need around traditional well-underwritten mortgages.

Mr. BACHUS. All right. Let me say this. I now agree with you, but you cannot assume in a study that you are going to make those changes in Basel I and know what that effect is going to have when you have not even made the changes in Basel I. What you are saying is, if we change Basel I, we probably will not have this competitive disadvantage. We have not changed Basel I. Do you agree that maybe we ought to change that before we make an assumption? Your latest economists, they said that basically these small banks could reposition their portfolios. Or what you are saying is that we are going to change Basel I so they will not be at a disadvantage.

Ms. BIES. What I am saying, is for the loans that are put in the portfolio that will end up being a competitive disadvantage for the safest mortgages because the big institutions already are taking

those loans off their books, they are already able to get around the existing capital limitations that Basel I puts on them. For smaller banks, it is more difficult for them. They do not originate enough deal flow to pool these mortgages effectively. So they very often keep mortgages on their books, especially non-conforming. That is the issue that we are trying to deal with in terms of capital on the books.

Mr. BACHUS. I guess what I am saying, this latest Fed study which contradicted the first did not say in there, now, we are going to change the requirements in Basel I and it will allow these small banks to not be at a competitive disadvantage. It assumes something without saying it.

Ms. BIES. It was really focusing on the impact of the securitized conforming mortgages. What I am saying is that it is a broader question. There is more variety of mortgages today and I think by looking at both of these aspects, we can understand that banks are trying to innovate to serve their various customer needs. And as they innovate we need to make sure that the risk framework, whether it is the banks in Basel II or the banks in Basel I amended that are going to have the flexibility. If there are riskier loans, capital should go up. If they are less risky, it should come down, for both sets of banks.

Mr. BACHUS. I guess what I am saying, and my time is over, but you also assume in this second study that the GSEs and the way they do business is going to remain the same.

Ms. BIES. We made that assumption because it is unclear exactly how they would change.

Mr. BACHUS. That is right, but that is a pretty big assumption.

Ms. BIES. It is a big assumption.

Mr. BACHUS. Thank you.

Ms. Maloney?

Mrs. MALONEY. Thank you.

Following up on the chairman's questions, Honorable Ms. Bies, on page seven of your testimony you note the heavy investment in systems and processes that U.S. Basel II banks have been making. You express concern that these banks not be placed at a competitive disadvantage vis-a-vis a foreign bank by a delay in the rulemaking.

But in light of that recognition and following up on the chairman's points, how can the Fed argue that banks which compete with non-banks or smaller non-Basel II banks will not also be at a disadvantage because they would hold more capital than their competitors?

Ms. BIES. I think I want to differentiate here between what we are trying to do on the international front and the domestic front. In the U.S., we have chosen to only mandate the very large complex organizations to go into the advanced approaches to Basel II.

We did that because we are concerned that for these complex organizations, the existing capital framework is so simple because it ignores so much of the risk that is off the books, that we need to get something that reflects the evolution they have. They keep inventing new types of financial instruments, new deal structures. Items are off the books so they are not visible in the traditional capital framework.

As they keep evolving in that way, we need to make sure that capital reflects risk around the way they are managing their product lines and their customer exposures. We do not expect that any mid-size or small bank would necessarily make these investments in these sophisticated risk tools. But we do expect today, under our supervisory framework of safety and soundness, that any sophisticated bank that deals with these tools has already in place a strong risk management framework. So depending on the large banks that you are describing, for many of them they are in the process of extending databases, but they already have a framework that looks at risk in a very sophisticated way.

The formula, for example, that you mentioned that is posted here is one of those aspects on how loan pools are put together to look at different risks in different branches. We actually proposed at one point a more simplified version of that formula, and the banking industry came back and said no, that they felt it was not reflective enough of risk and wanted us to move to this version of the formula because it better reflected the different risk aspects that are used as loans are being securitized.

The fact that these organizations are engaging in this sophisticated activity and we already are looking at them and expecting them to have systems in place to understand various aspects of risk, it is an easier evolution for Basel II for these organizations than institutions who would not undertake these sophisticated transactions. That is why we have to keep a very simple framework for the banks that are not in Basel II, but make sure that an answer is comparable on the risk that results.

Mrs. MALONEY. But these systems that they have put in place, according to this QIS-4, are flawed. They are coming forward with very different risk and very different capital requirements, and no explanation of why similar institutions have such large different results. So it seems that if we keep going forward, in a sense, you are encouraging a flawed system that would aggregate the competitive problems that we were suggested in the QIS-4 study.

Ms. BIES. I agree that all of the results in QIS-4 for every bank are flawed in the sense that today no U.S. bank would qualify for adoption of Basel II. None of us would qualify any of these banks. Remember what the QIS process was designed to do. This is the fourth one we have done. We did these periodically so banks who are thinking about going to Basel II could use it as a milestone to sort of say how are we progressing and what are the issues we need to be focused on. We could use it as a check for whether the framework had issues we had to deal with.

If you look at individual banks, and we are still doing this, one of the things you find is that, for example, some banks did not have a process in place for certain portfolios or loan types or risk elements. As a result, it is zero. Well, if you put in a zero because you did not complete that part of the exercise, you are adding in a zero. And we know that clearly is not the answer.

If we look at banks that we would expect similar results, one of the issues we have is their database limitations. Some do not go back very far. We have been very lucky in this country in the last few years. Credit quality has been extraordinarily sound. We are expecting when this gets done that the databases for credit risk go

through a credit cycle. Right now, the databases only have the good years, and when you only have the good years, you are necessarily going to have a lot less capital than if your database includes the bad years in a credit cycle, and that requires more credit.

Most of the banks in this process did not have that full cycle of data underlying their loans, and that is another reason. That is what we are trying to do, is to separate out the reasons for the differences and begin to focus on where are they in their development process and where are we needing to make changes in the existing framework.

Mrs. MALONEY. Then why did banks with similar portfolios end up with different results? You say that the database had limits. Is that the only reason? What about different applications? Why did it end up with such different results?

I would beg the chairman to allow other members of the panel to answer because that is the basis of this hearing. It is why did we get such different results with similar banks and similar portfolios? What is the explanation?

Ms. BIES. Again, let me just make one other point. This is why we are trying to do this delay to find out the facts. We do not have all the answers yet. I am saying that the initial results, banks we thought should be the same, for example, there are parameters and models that are different.

One of the requirements we say you have to look at what in a downturn stress situation of credit losses, what would your estimate be. Some banks have not put together any methodology to get to it, and actually there is nothing there for that effect. If banks are having difficulty coming up with that, then that is a signal to us as regulators that we may have to mandate an assumption to get everybody who has similar credit portfolios to use the same parameters in their models.

Mrs. MALONEY. Okay.

Would anyone else like to comment on this? Ms. Williams?

Ms. WILLIAMS. Congresswoman, the basic answer to your question of why there are these differences is that we do not know yet. That is exactly what we are drilling down into right now. That is what this whole QIS-4 process is about—enabling us to understand better how these processes work. So I would like to characterize the QIS-4 process and the results of the QIS-4 process as a good thing. This is showing that the process that the agencies have in place to work through the implementation of Basel II is proceeding in a careful and judicious way. We decided we need to slow down here and understand better the numbers that we have, and that is what we are going to do.

Mrs. MALONEY. Thank you.

My time is up. Thank you, Mr. Chairman.

Mr. BACHUS. Thank you.

Chairman Pryce, I want to commend you on your preparation for this hearing and your support.

Ms. PRYCE. Thank you.

I appreciate this opportunity, and I want to thank the panel for helping us understand where the regulators believe we are in this process. I believe we are at a pretty critical stage. There are obviously some significant problems with the implementation of Basel

II, but there is a possibility of a competitive disadvantage for U.S. banks in the international marketplace if there are not the appropriate changes currently made in the capital requirements.

My question to you all is, does it make any sense at all in ordering that the noncontroversial parts of the accord be implemented sooner? Then the regulators can go back and work on the remaining provisions that are more controversial for future implementation. You know, just kind of pick the low-hanging fruit, get started, get up and running, and then work out all the details and not have to have the perfect final product before we can see some advancement. Has there been any discussion of that? If it is a bad idea, can you tell me why, any of you?

Ms. BIES. Let me start. Right now as we look at QIS-4, and as we move forward in the Basel II process, we are going to be looking at those kinds of issues. Clearly, we are running into different issues around different aspects of risk. The one example I just mentioned about what do you do with a downturn stress situation, a severe recession. Because we did not capture the kind of data we want in these models back in the 1980s, the last time we had such a time, we may need to simplify that and put in a temporary assumption until we have used these models through a crisis scenario. In that sense, it is simplifying and we can get to a decision relatively quickly.

Another example is the operational risk information. We have been collecting data from the banks that are participating in the process, and we are putting together at the Federal Reserve Bank of Boston a significant database on operational risk that has millions of entries to date. This is one way to develop deep enough databases that can either be shared with or amony banks, so they do not have to incur all the costs on their own or as a basis simplify or modify the assumptions. We could look at that alternative.

We are really trying to think outside the box and respond to the industry and also be sure that the framework is sound in a risk-focused approach, and we will be considering those alternatives as we go ahead. I think the one thing we need to be careful about doing it piecemeal is that we really think through what the implications could be in different product markets and the competitive impacts in the United States. We need to think that through as we go forward.

Ms. PRYCE. Anybody else?

Ms. WILLIAMS. I'd like to offer a complementary perspective on this. The U.S. regulators chose to implement the advanced approaches for Basel II because we felt that that ultimately was the best way to end up having a truly risk-sensitive capital regime. It is very hard to pull apart pieces of an advanced IRB approach or an advanced approach for op-risk and do a partial implementation.

What is possible in moving ahead with the implementation process is to make sure that you have safety nets, stopgaps, prudential provisions in place so that you are comfortable with the implementation process as it goes forward. Those are some of the things that Governor Bies was mentioning as possibilities. What we hope we will discover as a result of our deeper analysis of the QIS-4 data is which of those ideas, and maybe others, make the most sense to use based on the circumstances.

Ms. PRYCE. I hope, because we are moving the timeline again, advancing it, and so I hope that some good comes of this, that perhaps it will advance some of this as opposed to postponing it.

Let me change gears real quickly. I would like to talk about the competitive impact on U.S. financial services firms. Last June, there was a hearing on private sector perspectives. The subcommittee received testimony that a number of large U.S. security firms are going to be subject to Basel II through registration with the SEC, pursuant to a new regulatory framework for consolidated supervised entities.

Are you all working with your colleagues at the SEC to ensure an equitable application of Basel II as applied to those firms? Is the goal to apply Basel II with due recognition of the differences between banks and securities firms? Who would like to field that one?

Ms. WILLIAMS. There is coordination among the domestic regulators. There is also coordination in the international arena with the international securities regulators and how their implementation of Basel II intersects with the bank regulators' implementation. So yes, there is coordination.

Ms. BIES. Let me just make you aware that as part of what Ms. Williams just mentioned, the Basel Banking Committee and IOSCO, which is the equivalent, the International Association of Securities Regulators, of which the SEC is a member, just published a few weeks ago a regulatory capital framework that is risk-based for what we call trading book assets, which is the biggest part of securities firms' balance sheets.

The idea is that we will end up with a common risk framework between both securities and banking regulators, not only in the U.S., but internationally. Those comments are due at the end of this month. It will take us a while to look at it. Clearly, what we are going to learn from that, we will also incorporate into the NPR and Basel II going forward.

The fact that this being done on an international basis I think is another signal that we are trying to make sure that similar risks are treated in the same way as we can for risk-based capital purposes no matter what the charter of the organization may be. So we feel that we are making much more progress along those lines, and this new proposal that was jointly issued by both IOSCO and the Basel Banking Committee I think is good testament that we are working together. There are other aspects of coordination that we are still working through, but this will be the meat of what needs to happen to go forward.

Ms. PRYCE. Thank you.

My time has expired. I want to thank the panel once again, and especially thank the chairman for holding this important hearing. Thank you.

Mr. BACHUS. Thank you, Chairman Pryce.

At this time, Mr. Ford?

Mr. FORD. Mr. Chairman, thank you.

And welcome again to the panel. I am sorry that I was late arriving.

I wanted to especially extend a welcome and even a belated happy birthday wish to Governor Bies, who hails a good part of her

life from my home city of Memphis. I am delighted to see you and welcome you and thank you for your enlightened insight in remarks today.

I know that you have been introduced already, and I hesitate to say, but I do my banking at her bank, at her former employer where she was a long-time Executive Vice President for Risk Management and held a variety of titles at the bank. She is widely regarded and thought of back home. As we can all deduce from her testimony today, we can all see why.

I appreciate your emphasis, Governor Bies, on the quality of research and your willingness to move at a pace and speed that allows us to get all the facts on the table. I was interested also in hearing the answer to Chairwoman Pryce's question as well. I think you put some of it in perspective for all of us.

My question would really be directed to Director Curry, if I could. I know that in your testimony, Director, you mention that the FDIC has some concerns about the lack of accounting in Basel II's accounting for emerging business lines. I am just curious to know if you would elaborate on how great a risk you think this poses to the banking system and to the implementation of Basel requirements going forward.

Mr. CURRY. Our concern is when you look at some of the results of QIS-4, particularly with respect to home equity lines of credit, that there have been changes in the marketplace in terms that the product itself and some of the risks behind it, that the capital levels be representative of those risks. The home equity lines is an example, but there are additional products being developed in a very dynamic banking industry, and our concern is that those measurements reflect those risks.

Mr. FORD. We had, Governor Bies, not long ago before the committee, through Chairman Bachus's leadership, a hearing on Check 21 and the impact that has on community banks. The head of the Independent Community Bankers Association is from Dyersburg, Tennessee, David Hayes. He came on behalf of obviously his association to express their concerns. They were here, and have been here the last 2 days, and even expressed some concerns about this as well, knowing that you were coming before the committee.

So I am pleased to hear your remarks and even others, and I hope that the committee will take into consideration all that has been said and whatever we do to act, that we act in a way that will not impact negatively the obvious kind of deliberate effort that you have underway.

I would be remiss if I did not give you an opportunity. I know you have had the chance to kind of dominate the talking here on the panel, but it is my 5 minutes so I can do what I want with it. You have a good colleague with Laricke Blanchard. He is from Memphis also, with the Fed Reserve Board.

But I would love to hear your response to Curry. That is FDIC work, but you have had your vantage point on this issue. It has been pretty varied like most of your colleagues as Governors. How do you respond and how would you react to that question as well?

Ms. BIES. I agree with Director Curry in terms that it will be a challenge to look at any new product initiative. We will have to determine how and when that gets incorporated into an individual

bank's capital requirements. As safety and soundness regulators, we already are looking at new product introduction processes, and we require banks today, if they enter into, say, a new loan product, they have to today account for credit risk. We would expect that they price for that credit risk. We would continue to give guidance on the safety and soundness aspect of these.

I think one of the reasons for the concern for the banks that put mortgage loans, for example, in their portfolio is they are stretching and putting the higher-risk loans in the portfolio because the capital requirement was placed too high for the traditional conventional 30-year fixed rate mortgages. But stretching to take on riskier loans may make the current capital requirement under Basel I too low. That is one of the challenges we have with any new product is how do you make that determination as to the appropriate level of risk.

We also know that as banks merge they are going to have conversions going on where they standardize products, get their systems in conformance. Again, it will be a combination of safety and soundness reviews and potentially this is where we can use some of our discretion as regulators to put a qualitative amount in Pillar 2 if necessary around risk.

So I think we have a lot of tools. We just have to realize that all of this risk framework is not precise because you are looking forward using historic data. Any model in that sense has got some limitations. But we need to make sure that if people are putting long-term risk on their books or securitizing long-term exposures, that that is reflected in their capital and not just the moment in time. So we will have this issue with both Basel I and Basel II.

Mr. FORD. Thank you.

Mr. Chairman, I know my time is up. Thank you.

Mr. BACHUS. Thank you.

I would like to say that Representative Ford and Representative Biggert, who is next in questioning, were both original cosponsors of the legislation that we have today, H.R. 1226, which expresses our concerns about some of what we are hearing today, and I think substantiates the wisdom of that legislation. I want to commend both Representative Ford and Representative Biggert as original cosponsors and recognize the lady from Illinois at this time.

Mrs. BIGGERT. Thank you very much, Mr. Chairman.

Thank you, Mr. Pearce, for yielding to me.

Let me start by saying that I am concerned about the state of play. In your testimonies, saying that you as the supervisory community, it sounds like from your testimonies that you could be comfortable with the variances in QIS-4 if that variance were driven by portfolio risk rather than model differences. Could someone explain to me what is the difference between these two choices, since models define portfolio risk?

Somebody want to take a chance?

Ms. BIES. I will answer your question. The models that banks are using right now are, and let me start by saying we are still getting this information, but they are in different stages of development. What we are trying to understand is if one bank has 30-year conventional mortgages, say, on their books and they are modeling credit risk, and another bank has the identical kind of credit qual-

ity, same kind of mortgages, the model that they are running, does it make different assumptions; does it have different parameters; is the database shorter versus longer? One may include data all the way back to the 1980s or throw in proxies for the housing losses that occurred in the oil patch, say, in Oklahoma and Texas in the 1980s as stress scenarios.

The other bank could be saying, well, all I have in my database is the last 2 years, and credit losses are very, very low. If you do not include the extreme events in your database, you can end up with different answers, even though the loan quality is the same. That is because the framework of risk-based capital looks at the extreme events. In other words, you assume that normalized losses and charge-offs banks should be able to cover through normal operating earnings every day, every month, every quarter.

What you need capital for, and what we as regulators are focused so much on, is do you have enough capital to get you through the stress periods, the downturn periods, the really rough times? We worry about it as bank supervisors since that is when you call on capital to absorb losses.

So if your database does not include those extreme events, you can end up with a different answer. Obviously from the Federal Reserve's perspective, as a central bank, we worry about systemic risk. If everybody leaves out those extreme events, then there are implications that the banking system may not have enough capital in tough periods, and additional measures may be needed to get the economy turned around if we do not have a healthy banking system in a recession.

So that is an example of even with the same kind of quality of the loan portfolio and you could end up with a different answer if you do not have similar information going into the models.

Mrs. BIGGERT. So do you want variance and risk sensitivity in the same capital framework?

Ms. BIES. We want to be able to measure risk in a similar way across the banks. One of the challenges that we have today is that in Basel I we just look at mortgages from a very simple framework, or commercial loans from a simple framework, when we know individual borrowers or the facilities structure for individual loans to the same borrower expose the institution to very different kinds of risk. If we have the same number, what is in effect happening is banks to cover that capital will take on higher and higher risk in order to leverage it more, which adds systemic risk to the banking industry.

Mrs. BIGGERT. Then how do you know whether you have crossed the line into micromanaging credit decisions and eliminating risk altogether?

Ms. BIES. We will not eliminate risk altogether and realize that the term "risk management" is chosen for a specific reason. We are not telling banks to minimize risk, avoid risk. We are saying whatever risk you choose to take, you need to manage it well. These models that the banks are building should reflect their risk appetite, their ability to manage that risk, and the controls they have to make sure the risks they thought they were accepting, they have.

So it is really targeted around their ability to manage risk. We are not micromanaging. We just want to make sure whatever they are choosing to do, that the risk management is appropriate. That is one of the reasons for the smaller banks; we do not need to build these sophisticated structures. They are into much simpler products. More of their products are on the balance sheet, so they are easier to see and visible to readers of financial statements and to examiners. It is the sophisticated instruments where it is harder to understand the risk that we are requiring a stronger risk management process of which capital is one piece.

Mrs. BIGGERT. There is an old saying that you learn by your mistakes. It sounds like the market should not be permitted to make mistakes.

Ms. BIES. No, the market is going to make mistakes. Individual institutions will make mistakes. Again, when you look at models, the one thing that worries us all is what have you not put in the model that could really affect you. That is why I think for us to be good supervisors, the capital framework has got to be part of the supervisory process. We can use supervisory processes to ask questions and check ourselves to see what is the model missing. We can overlay the two and put another mitigating control for risk exposure in there through the supervisory process.

You cannot really have good risk management processes in total by only using risk-based capital. You have to have good risk management and supervision with it to try to minimize the risk of some severe unexpected event happening, but that does not say we can always avoid it. There are always going to be surprises.

Mrs. BIGGERT. So what you really have to do, then, is tweak all the various assumptions and parameters in the complex formula. Will you do that in Basel I plus II?

Ms. BIES. We are in the process of drafting this, and I will let some other folks talk about Basel I, but we would expect that we would do the same thing, but do it in a very simple way, base it off the call report the banks use today and not create the need to invest in sophisticated models for the banks that do not have sophisticated products like the big international banks in Basel II.

Mrs. BIGGERT. Okay. Just to go back to the first part of the question about the variance driven by portfolio risk rather than the model differences, it sounds like it would be the portfolio risk, would be the choice.

Ms. BIES. If everything was done the way we would perfectly expect it, if you looked at the risk-based capital of two institutions and one was more than another, you could say that that institution had either riskier exposures or a larger amount of the same exposure. In total, their risk would be bigger, but it could come from either way.

Mrs. BIGGERT. Okay. Thank you.

Thank you, Mr. Chairman.

Mr. LEACH. [Presiding.] Thank you, gentlelady.

Chairman Oxley?

Mr. OXLEY. Thank you, Chairman Leach.

Governor Bies, you talked about Basel I rules and Basel I(A), I guess, in between. Do you have sufficient resources to work on both proposals simultaneously? That is, the interim effort, as we proceed

toward Basel II, are you in a position to handle both of those at the same time?

Ms. BIES. We are in a position to handle both at the same time, because I think it is important to implement both of these together. We have people that are assigned special responsibilities under each one, but the dialogue needs to happen among all the staff and Governors involved in this process because we are dealing with similar issues for both amending Basel I and developing Basel II. We need to constantly have a touchstone between the two to make sure that what we are moving forward is going to be consistent and deal with some of the issues that this committee has already raised.

Our staff back here may feel that they do not have enough resources. We are adding staff if we feel it is needed, but we feel comfortable that we can make the timeframe in terms of gathering information to support our decision-making.

Mr. OXLEY. That is encouraging. The leverage ratio is a one-size-fits-all approach to capital. It treats all assets on the balance sheet essentially identically. It sounds to me like to be the opposite of the approach envisioned under Basel II. Is that a correct assessment?

Mr. RICCOBONO. It is. The problem, as I stated in my testimony, Chairman Oxley, was what we have done is leverage ratios are extremely important, and no one would suggest that we should not have it in the Basel II capital framework. But the problem is the leverage ratio that we currently have in place is in fact compatible and exists as a safety net or a fuse for the rules that we currently have in place under Basel I. All that is being suggested, although forcefully recently, is the thought that if we are going to move forward with Basel II, we need updating in our approach to capital, and we need to think about including there an update of the safeguards with respect to capital.

You just cannot use the fuses that we put in place for a system that was much less, 115-volt system when we move to 120-volt system. We need something more like circuit breakers, than old-fashioned fuses. That is really what the problem is with the leverage ratio. We can do some serious damage to our institutions by encouraging our lowest credit-risk institutions, our most conservatively invested institutions, encourage them to take more risk simply to take advantage or maximize the fact that they are going to be required under an old existing leverage ratio to hold more capital than the Basel II approach.

If their information is sufficient and robust, it says they can hold less. Well, we should not then require a greater amount of capital that they would have to then manage to. It makes no sense to put that in place. So we think that a risk-sensitive leverage requirement is necessary in a risk-sensitive capital environment.

Mr. OXLEY. Do we have agreement on that with the rest of the regulators?

Mr. CURRY. Chairman Oxley, from the FDIC's standpoint, it is critically important that we have a valid, functioning leverage ratio. When we talk about questions about the accuracy of models, where we are dealing with the Federal safety net, particularly the deposit insurance aspects of it, we think it is critically important

to have that cushion of the leverage ratio, notwithstanding the state of art in terms of credit risk management.

We would point especially to the history of the financial system in the United States, the S&L bailout, the issues with long-term capital management as examples of where if there are errors in models, there are significant consequences, and we need to take a conservative approach.

Ms. WILLIAMS. Mr. Chairman, I think that we feel that it is a tremendous undertaking to implement Basel II. The leverage ratio is not on the table.

Mr. OXLEY. I am sorry. What was the last part?

Ms. WILLIAMS. The leverage ratio is not on the table.

Mr. OXLEY. Any response?

Mr. RICCOBONO. Yes, I just think it has to be on the table. We cannot go forward with Basel II unless we figure out how we are going to continue, if that is where some of us are, that we are just going to continue with the existing leverage requirement, and not broaden those consistent with the modernization of the capital framework. It is not going to work. We are going to have unintended consequences that when we finally figure out what we have done, it will be too late.

Mr. OXLEY. Governor Bies?

Ms. BIES. Chairman Oxley, I think our perspective on the leverage ratio is that today's leverage ratio really is not reflective of risk because institutions have evolved. It is based on the balance-sheet exposures as risk off the books. But I think we would support the OCC's position that we have a long way to go along Basel II. We ought to leave our one anchor there in place, especially in terms of prioritization of the work we do.

The full impact of Basel II does not go into effect anyway under today's timeframe until 2010. We will have plenty of time when the banks are further along on the adoption to come back and look at how, if we do want to change the leverage ratio, how would we do it, but I think it is premature today to start that dialogue.

Mr. RICCOBONO. This needs to all be done before we set sail. We cannot set out for open waters and decide we are going to then determine whether the vessel is seaworthy. That is I think unacceptable.

Mr. OXLEY. So the disagreement continues, basically, between the two regulators.

I yield back.

Mr. LEACH. Thank you, Mr. Chairman.

Let me just ask Mr. Pearce a question. You are up next, sir. You can start now, or if you would rather wait until after the vote, it is up to you. You will have about 4 minutes now, but after the vote you would have a bit longer time. What is your preference? Fine. Mr. Pearce, you are recognized.

Mr. PEARCE. Thank you.

Ms. Williams, you might not be the best one to answer. I am sort of lost, but we have heard testimony about different risk management tools. Give me a short list of risk management tools that are being used to help banks. If not, if someone else could give me a better answer?

Ms. WILLIAMS. Congressman, banks use a variety of——

Mr. PEARCE. Just a short list.

Ms. WILLIAMS. They look at their past experiences with different types of credit to try to identify where exposures can arise. With respect to particular types of loans, they look at factors that are risk factors for particular types of borrowers. In the consumer area, there are very, very sophisticated risk factors that are used in connection with credit scoring for retail type loans. In the wholesale arena, there are databases of the performance of different types of loans and different types of obligors that banks will look at in order to try to identify risk factors.

Mr. PEARCE. Thank you.

Governor Bies, as near as I can summarize, we have the question of international competition and the question of domestic competition, and we have the question of national economic strength and international economic strength. Of those, which would be the highest priority in your mind when trying to solve the questions in front of us about Basel II?

Ms. BIES. Speaking for myself, I think the most important thing is that we are comfortable that banks in the United States, whether this is their home country or foreign banks operating in the United States, have enough capital to cover the risks that they incur operating in this country. We need a strong, sound banking system to keep our economy strong. I think it is one of the reasons that the U.S. economy has done so well in recent years compared to some other countries is that we have a very strong banking system. As a central banker, I would put that priority first.

But we need to realize that the world has evolved. Institutions now are able to globally span, in part is it because their customers, if they are dealing with corporate customers, are operating internationally. So to be effective and keep the world economy going, we have to deal with that issue. But I would say the first priority would be to look at the U.S.

That is why I think it is important that we continue with the time framework and the work plan that we laid out initially, where we are working in both directions at the same time, making sure the Basel I changes are out the same time as Basel II, that we are looking at the impact on the U.S. industry. And then we keep working with our fellow regulators from other countries around the Basel table and with IOSCO around the securities aspects to make sure that internationally we are ending up with a uniform, as much as we can get it, a uniform approach to capital and risk.

Mr. PEARCE. You had mentioned that one of the problems today is that different banks are arbitraging their assets.

Ms. BIES. Yes, the larger organizations——

Mr. PEARCE. That was a statement you made.

Ms. BIES. Yes, yes.

Mr. PEARCE. Is that practice one that you would approve of, or do you think it is something that we would try to get around in the next regulatory cycle?

Ms. BIES. Generally they are arbitraging it to the extent I think it is good because they are saying if we can syndicate a loan, securitize an exposure, enter into a derivative transaction, and have someone outside the banking system take on risk, then the

bank is stronger and banking system is stronger. The important thing is to understand how it is done.

Mr. PEARCE. No, no. Stop right there. Okay, going back to my initial question about the tools, the risk management tools. So my question is, if we shift risk outside the banking system, and if our formulation for securing the Nation's economy, therefore the world's economy, is based on factors inside the banking system, it seems to me that if you do not have a risk assessment that also then brings in those outside institutions, entities, tools, concepts, that you are still at as great a risk as you were before you shifted the risk outside, and for us not to acknowledge that.

In other words, I do not know much about risk avoidance. I am in politics and I am married, but I know that if you say if they move into hedge funds, and hedge funds are not evaluated in your formula, and I read all through this formula, and I do not see hedge funds.

Do you see what I am saying? It is that we are fooling ourselves to an extent, that if we can just get the risk outside the system, that we will be okay. I worry deeply about that concept.

Ms. BIES. Let me put it in a different perspective. What has evolved really in the last two decades is risk management processes where institutions can keep the risk, and these are sophisticated institutions, can keep the risk they understand best and can manage, and place the remaining risks with other sophisticated investors. These are sophisticated investors because they do have to understand what it is that they are acquiring, whether it is a mutual fund that is looking at the investor direction of that fund, whether it is going into a pension fund, and those fiduciary responsibilities.

The buyers of the risk in one way have better information than investors in banks. If you look at data today, we get real-time public data on credit card securitizations that tell you what is happening to current delinquencies and charge-offs. We do not get it if that same credit portfolio is sitting in the bank.

Mr. PEARCE. Mr. Chairman, with your permission, I know my time has expired and a vote is elapsing underneath my feet, but when I look at the German losses in Asia, when I look at the banking losses in Thailand, when I look at the current exposure in China with 30 percent nonperforming loans, I am sorry. I just worry about the capital requirements, and then I need to really feel we are headed that way. You can respond, and we will put it on the record, and I will read it, but I am just getting out of here.

Thank you.

Mr. LEACH. Mr. Pearce, I want to thank you for those thoughtful comments. We have an uncomfortable marriage at the table apparently.

Let me say to our panel, we have a vote on, and I would like to ask if you could remain for a bit longer. We will recess for about 15 minutes and then return to this panel before we start the next panel.

The committee is in recess subject to the vote. Thank you.

[Recess.]

Mr. LEACH. The committee will come back to order.

For the record, it should be noted that in the process of the vote, we had an emergency evacuation of the Capitol, and so we are reconvening at a later moment. The first panel was dismissed because of the emergency.

One of the current panelists is unable to return, and so without objection Ms. Shaw Petrou's statement will be placed in the record in full. Without objection also a letter from the Real Estate Roundtable will be placed in the record.

Before commencing, I want to make about 1 minute worth of comments, having not been able to address the first panel. I would just like to say that I think left out of the mix of discussion, with one exception, are four very big questions. The first question: Should there be greater attention to risk management techniques? That is an obvious yes.

But the second question is, whether there is a great case in today's economy worldwide for a reduction in capital in the banking system. One has to assume that that case is positive to go forth with new techniques that are on the table. I do not assume that that is a positive answer to the question of whether you have a reduction in capital.

Thirdly, is there an assumption that worldwide there is sophistication in the banking industry of various countries affected, as well as international regulators that are comparable in the United State? I think that is a very doubtful answer as well.

And then the fourth question is, does this better prepare us for an international emergency, whether it be economic or political? I stress the political because this little event of the evacuation of the Capitol is symbolic of the kinds of anarchistic kinds of acts that could end up affecting world financial markets. One has to be pretty confident that there is no emergency that is likely to affect international capital markets to put into effect systems that decrease the capital in banks.

Finally, I must say that one of the other questions that has to be addressed is whether it wise to reduce capital in foreign countries in the banking system, therefore putting pressure for competitive reasons for us to reduce capital here, therefore putting pressure for competitive reasons if we reduce it for big banks, to reduce it for small banks, and whether this is a wise course of action, to end up putting an enormous amount of power in other regulators in other countries in other banking systems.

I think these are questions that really at the root have to be asked because the testimony of the Federal Reserve of the United States today included a surprising amount of assessment that reductions in capital were far larger than expected, and that comparability of standards within the most sophisticated banks were far wider than expected, and, therefore, there is a hope that over the next 5 or 10 years that they will better understand the circumstance, and that we can move because of the hope that in 5 or 10 years we are smarter than we are today.

I think these are assumptions that are really open to very serious review. I would just like to conclude by saying, in my life I have always been a very, very strong Fed supporter, but I believe that we have gotten an incredibly interesting review of mathematical modeling that may have gotten out of hand and that today

I am a very, very strong Fed supporter, but more of the Federal Deposit Insurance Corporation than the Federal Reserve Board on this issue.

With that by opening statement, let me turn to the panel. We have with us Mr. William J. Small, who is chairman and CEO of First Federal Bank, representing America's Community Bankers; Dr. James R. Follain, senior vice president of Mortgage Valuation of Fidelity Hansen Quality; and Dr. Paul S. Calem, vice president for Loan Research, Loan Performance.

Let me begin with Mr. Small. Please proceed.

STATEMENT OF WILLIAM J. SMALL, CHAIRMAN AND CEO, FIRST FEDERAL BANK, REPRESENTING AMERICA'S COMMUNITY BANKERS

Mr. SMALL. Thank you, Chairman Leach and members of the subcommittee. My name is Bill Small. I am chairman, president and chief executive officer of First Defiance Financial Corporation, a public savings and loan holding company based in Defiance, Ohio. First Defiance is a holding company for First Federal Bank, and my institution will face direct competition from banks which comply with Basel II.

I appear today on behalf of America's Community Bankers, where I am a member of the board of directors. I thank you for this opportunity to present our views.

An announcement by the bank regulators about the most recent quantitative impact study for Basel II reinforces the importance of this hearing and congressional oversight of this process. The results of that study highlight the adverse competitive effects that Basel II could have in the United States. As ACB testified on this issue almost a year ago, we believe that the development and implementation of the Basel II accord would present a significant competitive threat to community banks unless it is balanced by a carefully revised Basel I.

Community banks would like to adopt a more risk-sensitive model such as that envisioned by Basel II. Unfortunately, the complexity and the cost of implementation of the Basel II model will preclude most banks from taking advantage of the positive benefits. The bifurcated capital system implemented without proper adjustments to Basel I will open the door to competitive inequities. For example, two banks, a larger Basel II bank and a smaller Basel I community bank like mine, could review the same mortgage loan application. However, under Basel II the larger bank would hold significantly less capital than the smaller bank, even though the loan would carry the same risk.

Capital requirements should be a function of risks taken. If two banks make similar loans, they should have a very similar required capital charge. The most recent quantitative impact study conducted by the banking regulators on Basel II shows evidence of material reductions in required capital for participants. 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 institutions compete head to head with community banks in the retail area. Retail lending, especially mortgage lending, is a

fundamental business of community banks. Unless Basel I is revised, smaller institutions will become takeover targets for institutions that can use capital more efficiently under Basel II. ACB is pleased that the bank regulatory agencies have agreed to review and revise Basel I and implement the changes concurrently with the new Basel II accord. Changes to Basel I can include more risk-weighted baskets and a breakdown of particular assets into multiple baskets that reflect differences in collateral types, loan-to-value ratios, and other factors.

Another alternative would be for the bank regulators to adopt a simplified risk modeling approach that is consistent with the less complex operations of most community banks. It is important that the agencies work cooperatively in this effort and that input be solicited from all affected parties. We would encourage the agencies to form an advisory group of bankers to participate in the process and to hold public roundtables on these very important issues. ACB plans to be actively engaged in this process, and we will assist the regulators in any way we can.

While we expect the regulators to work cooperatively in revising Basel I and implementing Basel II, we support the legislation sponsored by Chairman Bachus and Ranking Member Maloney. The legislation would require a unified U.S. position on Basel II and would require the agencies to evaluate and report to Congress on several factors. It is essential that the views of all interested parties are heard and considered and that any changes to capital requirements be done correctly.

In that regard, ACB believes that a leverage ratio should be retained for all institutions, although it may be appropriate to change the requirement from its present level. We also strongly support giving the Director of the Office of Thrift Supervision a formal seat at the table because of its status as a primary Federal regulator of approximately 1,000 banking institutions with over $1 trillion in assets.

We thank you, Mr. Chairman, and the rest of the subcommittee members for holding this hearing on the proper implementation of Basel II and the sensible revision of Basel I. It is vital to the competitive viability of community banks.

Again, I thank you, and I would be pleased to answer any questions.

[The prepared statement of William J. Small can be found on page 166 in the appendix.]

Mr. LEACH. Thank you very much, Mr. Small.

Mr. Follain?

STATEMENT OF JAMES R. FOLLAIN, SENIOR VICE PRESIDENT OF MORTGAGE VALUATION, FIDELITY HANSEN QUALITY

Mr. FOLLAIN. My name is Jim Follain. I spent nearly 30 years as an economist specializing in housing and mortgage markets.

My comments this morning are based upon joint work with Dr. Paul Calem. Paul has spent 20 years as an economist at the Federal Reserve Bank of Philadelphia and the Federal Reserve Board and studied many aspects of the banking industry. Paul and I appreciate the opportunity to share our views with you. We will sum-

marize the major points contained in the written statement we submitted to the committee.

Before getting to the primary subject of our testimony, we just want to express our support of the broad goal of Basel II, to bring out better alignment between regulatory capital rules and the riskiness of bank portfolios. Indeed, we have actually written another paper that offers support of the specification of the proposed minimum capital rule that will apply to an important asset type, the newly originated 30-year fixed rate mortgage for prime borrowers.

Today, we wish to offer our opinions about another aspect of the proposal, the potential competitive impact of the proposed implementation plan in the market for residential mortgages. We believe that the proposed bifurcated implementation plan in Basel II in the U.S. is likely to have a significant impact on the competitive landscape within the banking industry in its competition for residential mortgage investments. The primary impetus is the sizable decline in minimum regulatory capital requirements for residential mortgages that will be available to adopting banking organizations relative to the requirements that will continue to apply to non-adopting banking organizations.

The decline for adopters will likely trigger a regulatory arbitrage process in which non-adopting banking organizations may experience a non-negligible reduction in net income due to a reduction in their share of the market and the reduced price they earn on such investments. Based upon available data and plausible assumptions, we calculate the aggregate gain to adopters to be about $300 million per year once the Basel II plan is implemented. Losses to the non-adopters we calculate to be about $900 million per year. They stem from two forces: their share in the market decline and the income earned per dollar of debt owned declines.

These losses would not be uniformly distributed among all non-adopters. The mortgage specialist among non-adopters would be most impacted by the proposed rule, in part, because the marginal amount of regulatory capital will likely be the leverage ratio, and not the Basel I capital rule. A subset of these with relatively large amounts of ARMs, adjustable rate mortgages, would be among those likely to be most at risk from heightened competition from the adopters.

Potential and partial remedies to the problems we envision are possible. In particular, the capital rule pertaining to residential mortgages for non-adopters can be adjusted downward for the credit risk embedded in them. Something like the risk weights associated with the standardized approach would likely reduce substantially the potential for competitive inequities. These reduced risk weights would be assigned to banking and saving organizations with geographically dispersed investment portfolios and interest rate risk management systems and processes designed to keep such risks to levels acceptable to regulators.

We would be glad to answer any questions you might have.

[The prepared statement of James R. Follain can be found on page 63 in the appendix.]

Mr. LEACH. Thank you very much.

Dr. Calem, were you going to testify or just answer questions?

Mr. CALEM. Answer questions.

Mr. LEACH. Fair enough.

Let me first turn to Mr. Small, but for any of the three of you. It strikes me that we are in a bit of a different world than we have ever been in before, with the new reliance on derivative kinds of products. Derivatives are wonderful ways to reduce risk for individual institutions in individual circumstances, but there is an argument that sometimes the totality and size of the market may increase some risk to the system as a whole in the case of something that goes astray.

In this circumstance, there are two very large questions that I have never really heard addressed on Basel II. One is, in a world in which the notional value of derivatives is in the multi-trillion dollar range, the last I heard, six or seven times the GNP of the United States, is there a case for reducing capital in the system that should be considered compelling? Because if you have an emergency, you need to have a lot of stability.

The second question I would like to ask, and this is a really bizarre one because it runs contrary to all regulation in my lifetime that I know of. That is, there is an assumption that bigger institutions need substantially less capital than smaller institutions. The assumption goes along the lines that smaller institutions are smaller markets, too much concentration, and a bigger institution has wider portfolios, et cetera, and wider diversity.

But this really can be carried to an extreme. I contrast capital ratios, for example, in my rural State of Iowa, which is considered disproportionately agricultural. It is not as much as people think, but it is disproportionately so, versus New York. Capital ratios in a community bank in Iowa in terms of tier one capital are very often four-fold a larger bank, sometimes six-fold a larger bank. And capital is the way one controls market presence, in other words, the competitive nature of the landscape. And so one of the really big questions is, in this world that is so complicated with the big playing such a large role, might there not be a case that the big should be required to have increasing amounts rather than decreasing amounts of capital?

I would like you to address both of these questions. Does the fact of the threat to the stability of the system of derivatives mean that we should be more concerned, rather than less concerned, with capital? And does the fact that the big have surprisingly small levels of tier one capital imply that our real concern should be raising their capital base, rather than lowering it?

Let me ask this first to Mr. Small.

Mr. SMALL. First of all, we certainly support the fact that there still needs to be a leverage ratio out there. But I do believe that especially since the implementation of Basel I back in 1988, at least in a general sense we have all hopefully become much more sophisticated in our risk measurement and risk management tools that we use in our institutions.

That being said, we still support the fact that we do need to have a minimum leverage ratio. We think it needs to be looked at. There needs to be some flexibility, I think, in where that level is set. At this point in time, I am certainly not prepared to speak for where

we think that level should be, but we certainly think it needs to be reviewed.

From the standpoint of the larger institutions and whether they should possibly be carrying more capital because of their diversity products and services and instruments that they are utilizing on a daily basis, again hopefully because of their size and their risk management procedures that they have in place right now, that they have taken the precautions necessary.

As you mentioned in your opening remarks, nobody can control what happens in the event of a catastrophe such as we experienced a few years ago; that certainly could have a major impact. But for day-to-day operations, I am not going to sit here even as a smaller institution and argue that I think the larger ones should have a higher capital level.

Mr. LEACH. Let me be very precise.

Mr. SMALL. Okay.

Mr. LEACH. I do not think I described it precisely. I did not mean more capital to the smaller institution, but more capital than is currently the case, with the relative differentiation between small and large narrowing, rather than widening.

Mr. SMALL. In other words, are you saying should there be a higher capital level than what we require today?

Mr. LEACH. Yes.

Mr. SMALL. In my estimation, no. I do not feel that that is necessary.

Mr. LEACH. Let me ask the same question of the other two.

Mr. FOLLAIN. Sir, I am a mortgage specialist, Mr. Chairman. In the case of mortgages, I can tell you a couple of things. If a bank has a very geographically diversified portfolio, it probably needs about half the capital for credit risk than a regionally concentrated portfolio has. But the problem with mortgages is that most of the risk is on interest rate risk. So whether those diversification benefits, I do not think apply on the interest rate side as much as they do on the credit side.

Mr. LEACH. Yes, fair enough. That is interesting.

Doctor?

Mr. CALEM. Yes, Mr. Chairman, Mr. Leach, I would add that I think the market risk and interest rate risk aspects of bank risk are separately addressed in the regulatory framework. There is a separate framework for market risk that addresses derivatives in the trading portfolio. Interest rate risk is also addressed under Pillar 2 of Basel. I think overall that it seems to be appropriate. The Basel II accord is really meant to focus on credit risk.

I do agree that it is a legitimate concern that with all the focus on credit risk because of Basel II, some attention may be drawn away from these other risks. The framework is there to ensure adequate capital, but there may be a legitimate concern that the attention is being drawn away from these other risks which could be more substantial than credit risk.

Mr. LEACH. Let me just conclude partly with an observation to Mr. Small. The FDIC is suggesting there ought to be a lot more attention to maintaining a credible leverage ratio. The Fed today technically said in theory that was right. It strikes me, one of the things Basel II is doing is it is saying in an international setting

that may not be the case, where the FDIC might demand it to be the case here at home.

So it strikes me that if I were negotiating on behalf of the United States, which the Fed is doing, that we ought to in a panicked kind of way tell the Basel II committee we need to put more emphasis back on the leverage ratio as an absolute minimum requirement and that we ought to be listening to the FDIC very strongly in this regard because if we do not, all the international banks are going to be cutting back their capital substantially, then our large banks are going to say that is a case for competitive reasons they have to cut back our capital. Then our smaller banks are going to say that to compete with the big banks, they will have to cut back their capital too.

So it ends up that the banks outside of America are going to be having a profound influence on the safety and soundness of banks within America. Then because of the derivatives world in which everything is international, the whole stability of the derivative system is going to be based on the weakest, not the strongest, and we are going to have a larger number of weaker institutions. This is a bizarre circumstance, given virtually every scenario that I have seen in economics about the notion that the world financial system is based on reeds of strength, assuming everything is stable.

The minute you introduce startling instability, we have some problems. If you have problems, it is nice to have a little extra cushion. I see this as a movement away from cushions. Now do you see it that way, or do you see it very differently?

Mr. SMALL. I do not see it differently. I do agree, and I hope that the U.S. continues to take that stance. We do need a safety net. We have to have some minimum leverage ratios out there. I totally agree with that.

But I also think that it is time for us to reassess what the proper level for that is. Once we get that determination, I think it is important for us to try to drive that as far as the international market is concerned.

Mr. LEACH. Thank you. Let me just finally conclude with one aspect of the Fed testimony today that is truly profound to me. The Fed in its statement acknowledged that its requirements will be substantially stronger than are necessary. It said, however, we are going to have protection because the market will force people to have higher standards. That is their testimony. The market will force people to have higher standards.

I am a little bit in disbelief. I think there is a distinction between the public interest and the private interest. The public interest is for credible capital. A private institution in many cases wants to go at the minimum it can and leverage as much money as it can because it gets a higher rate of return for its shareholders. I think we have to have public regulation that protects the public first and not rely on others to assume that we are going to get higher capital ratios and they are required by public regulators.

I personally have never in my life read more unsure testimony from a regulator than I read from the Federal Reserve of the United States today. I think that that testimony ought to be read with great care by outside observers. The Fed has gotten involved in a process that it acknowledged in its own testimony is out of

hand. It did not say "out of hand." It simply said two things. It said the reductions in capital are far greater than it predicted, and it said there is no comparable standard within the banking industry for looking at this. That is in the United States banking industry, in the most sophisticated institutions.

It drew no conclusions about worldwide. If that is the case in the United States, what in heaven's name is it when you include 40 other countries with 40 other regulatory systems? I think we have been presented a truly interesting mathematical approach to new regulation, but as interesting as it is, it is something that we should be profoundly concerned about.

Anyway, I want to thank the distinguished subcommittee chairman, who has really led this committee in a very interesting way. My hat is off to him. Spencer, I want you to return to your chair and take over. Thank you all.

Mr. BACHUS. [Presiding.] Thank you, gentlemen, for persevering under the difficult circumstances. When I returned to the hearing, there was a line out the building. I figured it was people trying to get into our hearing. It must have been wonderful testimony.

[Laughter.]

I started back over here, and in the rush of people coming out of the building, I thought we had recessed the hearing. It turned out it was something else.

Dr. Follain and Dr. Calem, let me address this first question to you all. Your study on the effect of Basel II on the mortgage industry, the competitiveness within it, seems to come to a different conclusion than a later study by the Federal Reserve. Why do you think your results differ from their recent Fed study? I think I know part of the reason. They made some assumptions that simply are not true.

Mr. CALEM. Okay, I will take that question, Mr. Chairman.

The way I view the differences in our studies is essentially, like you say, a difference in some basic assumptions or the basic paradigm. A simple way to think about it, there are essentially three sectors in the mortgage market that are relevant to this question. There are the larger banks, smaller banks, and non-banks. Let's focus on the nonconforming market and leave aside the question of the GSEs and the conforming market.

I think the Fed view is that the regulatory capital arbitrage that is occurring now is essentially all that can occur. Right now under Basel I, it is clear that capital requirements for low-risk mortgages are too high and, therefore, there is a certain amount of arbitrage of selling the low-risk mortgages off to non-bank investors in the secondary markets. We are talking now about banks' nonconforming mortgages.

The Fed view is that what is occurring now essentially is all that can occur. When we change the environment between big banks and small banks, it will not have any effect except that the big banks essentially will no longer have to arbitrage. They will not have to sell what they are selling now. There will be a more level playing field between them and the non-banks. The smaller banks, for whatever reason, they are either already selling whatever they can sell or want to sell, or there is going to be no change in their incentive to arbitrage.

The way we view it is that with these three different parties, we agree with the first part that you level the playing field between the big banks and the non-banks. There will be less reason for big banks to engage in this regulatory arbitrage for mortgages and sell to the non-banks. They can now hold them and not have to hold as much capital.

We feel that there is going to be a new opportunity, in a sense, for the small banks or new pressure for the small banks to lay off that risk. I think what I heard Governor Bies say is that smaller banks do not have those opportunities to sell to non-banks. They do not have as much opportunity to arbitrage this capital for mortgages right now. The question is, well, if you remove at least the barrier allowing the mortgages to shift between them and the large banks, won't that have an effect.

We believe it will. We believe that there are clearly transaction costs in doing this regulatory capital arbitrage, selling loans, securitizing loans. We feel that the transactions costs for that activity for smaller banks will be significantly lower for those smaller banks vis-a-vis big banks than they are vis-a-vis the general market. Those loans will be able to transfer much more readily than they can now.

It is a big change in the environment. At the very least, we do not know that the relationship between small and big banks is the same as the relationship between small banks and the non-bank sector. We feel that the transfers that are not occurring now will be able to occur because the relationships are different. There are correspondent relationships. There is direct competition in market share. So I think it is a very fundamentally different paradigm from the start, basic assumptions in terms of the regulatory arbitrage opportunities before and after.

That said, we are perfectly willing to acknowledge that we cannot make precise estimates of what the shift will be. Based on available evidence, based on some assumptions concerning the responsiveness of market share to these differences in cost, we have come up with a number. But we will readily acknowledge it is an illustrative number. Small banks obviously will have a competitive response. Maybe they will shift into other areas. But the basic theory is where we differ, and I think our view is that these numbers do illustrate the potential for a substantial competitive effect.

In fact, our numbers only look at first mortgages. When I was at the Fed, no one asked me the question why you include home equity loans in your calculation. That would have raised the competitive effect. No one questioned it. That was a clear omission. I would have questioned it myself, but no one asked me that.

Thank you.

Mr. BACHUS. Okay.

Dr. Follain, would you like to comment further?

Mr. FOLLAIN. I generally agree. A lot of my experience is based on my time with Freddie Mac when I was director of capital management for the credit risk side. I found it to be an extremely competitive business. A few basis points here and there mattered.

Mr. BACHUS. I am sure.

Mr. FOLLAIN. That kind of influenced my thinking. I was part of the alliance wars between Freddie and Fannie and big shifts in

shares during that time. So something like Basel II that has the ability to change capital so much, my intuition is you are going to see a lot of the kind of things Paul just talked about.

Mr. BACHUS. Capital requirements have always affected competitiveness, the amount of the reserve you have to hold. I mean, it would almost work against market forces for it not to have a significant effect.

Mr. CALEM. You can make a valid theoretical argument, which the Fed is making, that if there are three parties, the big banks, small banks, and non-banks, the non-banks already have that competitive affect. They are already drawing away the loans from then smaller banks, to the extent that is possible. Okay?

Our view is that with these three parties, that when you free another channel for that income to shift to, the big banks, that will have an effect. Not all of that income is shifting now to the non-banks. Some of it will shift once you open that other channel, which we feel is a channel with lower transaction costs, that income will shift to it. In theory, their argument has validity and, granted, it is very difficult to prove either theory.

Mr. BACHUS. Why should I as a policymaker, why should this Congress, why should it be concerned about potential competitive impacts of Basel II as a practical matter?

Mr. FOLLAIN. I think it is a great question. There are a couple of reasons. The part I want to emphasize is the importance of interest rate risk. I am a mortgage guy. I am not going to talk about other kinds of things. Interest rate risk is two or three times as great as the credit risk in mortgages. Whenever you change the competitive balance, the non-adopters, the ones being disadvantaged, I think it is going to have an incentive to take more risk. How do you do that in mortgages? You take more interest rate risk. That is one way. There is sub-prime and things of that sort.

What we would encourage you to think about—and there was partly a question this morning about adequate resources—I would just make sure that the system has enough resources to really measure and manage interest rate risk on mortgages because that is where the money is, as I used to say. I think as a policymaker, that is a really important issue.

Mr. BACHUS. All right.

Mr. SMALL. I also think the competitive differential that would result from this would certainly lead to some consolidation in this industry that really is not in the best interest of the general public. When you have the larger banks that increase the value of their currency because of the level of capital that they have to carry and also looking at the attractiveness of the higher capital levels of the smaller institutions, I think it is definitely going to have an impact on the consolidation of our industry, much more so than the normal cycle of business would have. Again, personally, I do not think that is good for the consumer.

Mr. BACHUS. Well, the existing consolidation within the U.S. banking industry is already a concern to the committee. I think it clearly would be accelerated by the regulatory capital requirements of Basel II.

Governor Bies today mentioned that if we change Basel I, I guess lower the capital requirements there for all the other banks to

more align them, that that would ameliorate some of the differentials in competitiveness. I suppose that would obviously be true. But is there a problem there?

Mr. FOLLAIN. I think for the bank that has a geographically diversified portfolio, a lot of things. There are ways of reducing the weights that would help. The problem, and it came up this morning on the risk adjusted leverage requirement, for the mortgage specialist who specializes in the adjustable rate mortgages, high quality prime mortgages, that would not be enough. You would have to do something with the leverage requirement, I think.

Mr. BACHUS. In fact, I think John Hawke has talked about that. I saw some mention of the fact that if you lowered those requirements, what if you lower them below what ought to be safe from a safety and soundness standpoint. You would not want to lower the requirements of Basel I if the requirements of Basel II are too low from a risk standpoint.

Mr. CALEM. I would reiterate that Basel II is only a credit risk standard. So especially when you are lowering risk weights, you have to put additional attention on interest rate risk, market risk, concentration risk, et cetera. If you have done that, I think once you have that monitoring in place, it is appropriate to lower the credit risk standard.

Mr. BACHUS. I will tell you that I am dealing with a new spokesman at the Federal Reserve. I can tell you that from the middle of last year to January when I read in the American Banker about your study, I had repeatedly asked them, is no one at the Fed concerned about competitive advantages? I was told by the Vice Chairman of the Fed that that was not a concern that had been expressed by anyone at the Fed. So I was surprised to see that you all apparently did not exist.

[Laughter.]

Unless the two of you all were doing that work in a closet and no one else knew about it or looked at it.

[Laughter.]

I do not know what you would term that or have some words you want to share at this time.

Mr. Small, let me ask you this. I know you are concerned about community bank competitiveness if Basel II only applies to the bigger banks. I guess that assumes no changes in Basel I. It may be hard to bring Basel II to all institutions because of what you talked about, the cost and the complexity.

There again, John Hawke, I will read you what he said, which I think ought to be disturbing to all of us. "The Basel II process has generated a product of vast complexity. Thousands of pages of task force and working group papers years in the making have given rise to hundreds of rules, guidelines, and standards saturated with arcane mathematical formulae." That is when I asked to see the formula, and I was shocked when they brought it to me.

I understand from the testimony today and what my staff tells me, you can change their variables within that formula, too, which makes it even more complex than what was displayed earlier.

Here is what he goes on to say, "They are not written by or for bankers or, for that matter, by or for conventional bank examiners. They are written for mathematicians and economists." He goes on

to say that "this complexity will have a cost in terms of credibility and public acceptance for legislators, customers, and market participants who cannot penetrate the new rules. Can we expect them nonetheless to love and respect them? I think it would be well to consider whether we are not approaching that point of perfect impenetrability that makes honest compliance difficult, if not impossible."

I guess if it is impenetrable to the point of not being able to figure it out, how do you comply with something you do not understand? If bank examiners cannot understand it and bankers cannot understand it, how do you comply with it?

Mr. FOLLAIN. May I just give you an example of the issue? We understand the formulas and there are people like that, but what I heard this morning was essentially what I think I heard was this one particular variable. It is the loss given a default. The range of estimates on that is very wide. That is a very important issue. In the future, you will want to focus on that one.

If you look over the last 4 or 5 years, when mortgages have been defaulting, the housing market has been great and they have not lost very much money. The OFHEO rules for Freddie and Fannie talk about a severity of 60 or 70 percent. So how they come up with that number is really critical.

Mr. BACHUS. Thank you, gentlemen.

Mr. CALEM. I would agree with Jim. I do not think the problem is so much the complexity of the rule as its application and the ability to calculate those parameters, the probabilities of loss severities from existing data, and the ability of the supervisors to validate those calculations.

Mr. BACHUS. Right.

Mr. Small, I guess part of my question was because of the cost and complexity, does it make sense to maybe have a simpler Basil I(A) or something? I think Chairman Pryce referred to that, just the fact that maybe we need to simplify Basel I or clarify it before we go on to Basel II.

Mr. SMALL. We certainly would not object to moving ahead with that. I do think that there is a strong case to be made for developing a Basel I(A), whether it is looking at more of the risk baskets or just from the standpoint of evaluating what is the collateral type, what is the loan to value, credit scores and so on, or whether it is a case of allowing the regulators to develop a more simplified methodology for developing that Basel I(A) level that does not have the complexity that Basel II has.

We certainly feel that there is a strong case to be made for that and also feel that there is no reason why that should not be pursued as we continue to work toward Basel II.

Mr. BACHUS. Okay.

I am told that I have to conclude the hearing. There is another hearing scheduled at 2 o'clock, and they have to clean up all this mess here that we have created. So with that, we are adjourned.

I want to thank you gentlemen for your testimony.

Mr. FOLLAIN. Thank you for asking.

Mr. BACHUS. Thank you for your contributions to this issue. Thank you.

[Whereupon, at 1:50 p.m., the subcommittee was adjourned.]

A P P E N D I X

May 11, 2005

Opening Statement

Chairman Michael G. Oxley

House Financial Services Committee

Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Domestic and International Monetary Policy, Trade, and Technology

Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study
May 11, 2005

I would associate myself with the remarks made by the gentleman from Massachusetts, the Ranking Member, Mr. Frank. Also, I want to thank Chairman Bachus and Chairman Pryce for calling today's hearing on the proposed changes to the Basel Accord. Chairman Bachus has been a real leader on the issue of Basel II reform. Significant changes to the proposal have been made in response to his concerns. Additionally, by bringing attention to this process, this Committee has seen increased cooperation among U.S. regulators who are developing Basel II.

Basel II is critically important to every bank in the United States, and the rest of the world. It will determine how much regulatory capital must be held to cover risks in bank portfolios, domestically and globally. Capital standards also influence market perceptions of a bank's strength, which directly impacts ratings decisions.

I don't think you will find much argument that the Basel Accord is outdated and needs revision. It was developed in the late 1980s, before liquid markets for credit had been developed and before the derivatives and securitization markets had taken off. These developments have made the Basel Accord obsolete and prone to abuse.

The most recent impact study conducted by the U.S. regulators, Q-I-S 4, shows major swings in how much regulatory capital banks using the new framework might need to hold. Participants estimated decreases of as much 40 percent; others estimated increases of as much as 60 percent from the current standard.

Even though no bank came close to breaching the leverage ratio, these kinds of results are unacceptable. No one knows why these results came out the way that they did. In other words, no one in the regulatory community seems to know how the new framework will affect retail credit markets in the United States,

particularly credit cards and mortgages. These market sectors are the backbone of the American economy and permit the United States to serve as the sole engine of economic growth among developed economies.

I believe it would be irresponsible to proceed quickly under these circumstances, and the regulators were wise to pause before finalizing Basel II. It would be helpful to know how the regulators are progressing with all of the various data problems and when we will have a greater understanding of the Q-I-S data.

I would encourage U.S. regulators to allow time for all the data to be understood before making any international commitments regarding final text and implementation. Regulators also should be discussing how they will cooperate in order to implement the new framework.

Significant changes to Basel II may be needed here and abroad before a final proposal is ready. In the meantime, I believe that U.S. regulators should continue working on updating the Basel Accord so that banks in the U.S. can benefit from changes in the obsolete framework while regulators try to put together a functional Basel II proposal. It seems that this would be the most equitable way to make improvements to the capital standards. I am interested in hearing what the witnesses think about this.

Thank you and I look forward to the testimony.

OPENING STATEMENT OF CHAIRMAN SPENCER BACHUS FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE, AND TECHNOLOGY SUBCOMMITTEE JOINT HEARING "BASEL II: CAPITAL CHANGES IN THE U.S. BANKING SYSTEM AND THE RESULTS OF THE IMPACT STUDY" MAY 11, 2005

Good morning. Today the Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Domestic and International Monetary Policy meet to examine the proposed Basel II Capital Accord and its potential effects on the domestic and international banking systems as well as on the recently completed fourth Qualitative Impact Study (QIS4). Today's hearing is the fourth one that the Financial Services Committee has held on the Basel II proposal since the 106th Congress. Prior hearings have highlighted disagreements among the federal financial regulators as well as substantive problems. During the last Congress, in response to concerns about the Basel process, I along with Congresswoman Maloney, Chairman Oxley and Ranking Member Frank introduced H.R. 2043, the United States Financial Policy Committee for Fair Capital Standards Act. The legislation — which passed out of my subcommittee by a unanimous vote — mandated that the federal banking regulators develop a unified U.S. position among the agencies prior to entering into negotiations in the Basel Committee. In March, Congresswoman Maloney and I introduced the same legislation, H.R. 1226, which currently has 36 cosponsors.

Let me start by applauding the banking regulators for delaying the Notice of Proposed Rulemaking to implement Basel II in response to the results of QIS4. I have been concerned that the regulators have been overly committed to an arbitrary timetable and have been making decisions that fit into their schedule without fully understanding the consequences. Many banks that may choose to adopt voluntarily Basel II have expressed concerns about being forced to make significant investments without having

the full knowledge of the impact Basel II may have on their operations. I am encouraged that the regulators recognized some of the problems with Basel II and hope that common sense will continue to prevail even if that means delaying the implementation of Basel II beyond 2008.

The goal of Basel II is to develop a more flexible and forward-looking capital adequacy framework that better reflects the risks facing banks and encourages them to make ongoing improvements to their risk assessment capabilities. Over the past six years, United States Federal banking regulators have been engaged in negotiations with their foreign counterparts on possible improvements to the standards that govern the capital that depository institutions must hold against their assets. The Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) participate in the negotiations on behalf of the U.S. It is expected that, when ultimately implemented, Basel II will apply mainly to the largest, most internationally active banks, and others that voluntarily adopt it. The remaining institutions in the U.S. will continue to operate under the original Basel Accord, or Basel I.

A growing international consensus has developed that Basel I is outdated and represents a one-size-fits-all approach to regulation, causing some banks to hold too much capital, thus diverting capital from productive lending activities. Additionally, the Basel Accord has been criticized for exacerbating credit crunches, creating incentives for banks to undertake destabilizing short-term lending in emerging markets, for not taking into consideration risk mitigation (e.g., collateral and guarantees), creating incentives for banks to securitize expensive assets (e.g., mortgages and credit card receivables); and for not addressing credit risk transfer through derivatives.

I applaud the intent and objectives of the Basel II Agreement: to ensure solvency of our banking institutions and protect against substantial losses by creating a more risk-sensitive regulatory capital framework, and to create international standards to manage

risk better by aligning regulatory capital to economic risk. Nonetheless, I have concerns regarding Basel II on several grounds.

First, I believe it is unnecessarily complex and costly with inflexible formulas replacing current rules and supervisory examinations. Neither the U.S. regulators, nor the Basel Committee members, nor the banks can estimate the cost of implementing the Basel II due to the costs associated with scaling for different sized banks and difficulties in assessing which costs would already have been undertaken by the banks in the ordinary course of business. No U.S. banking regulator, nor any member of the Basel Committee, has indicated whether sufficient resources exist to implement Basel II. The documents and chart in front of you illustrate this point. There are 187 publicly available documents related to Basel II, weighing 127 pounds. While some ideas included in these documents have evolved, the amount of paper demonstrates the complexity and micromanagement that Basel II represents. In addition, the chart with all of the letters and numbers is the Basel II formula itself. I have no doubt that there are very few people who understand this formula or its implications. It looks like a formula for micromanaging the banking business rather than one designed to align regulatory and economic capital assessments.

In addition, I believe that the current draft would create an uneven playing field – one that unfairly penalized many banks in this country, particularly our regional banks. Many believe that "Basel II" banks will have a significant competitive advantage because they will need to hold less regulatory capital for certain asset classes (for example, credit cards; corporate lending; mortgages) and because market participants (for example, swap counterparties; credit rating agencies) will perceive Basel II banks to be better managed than Basel I banks. I am also concerned that bank consolidation could be accelerated solely because of the regulatory capital benefits associated with Basel II implementation. The uneven playing field would carry over across borders, since the proposal expressly contemplates over 50 opportunities for local regulators to tinker with this formula. What's more, the Basel Committee itself has not yet figured out how regulators will communicate and work with each other to set meaningful regulatory capital requirements for globally active banks that have operations in multiple

jurisdictions. How one could end up with an international common standard in this situation is difficult to see.

Another concern that I have with the proposal is the treatment of operational risk. It is my belief that a supervisory assessment by the regulator as opposed to a regulatory capital cover is the better approach to limiting a bank's operational risk. It is my understanding that the databases are insufficiently robust for banks to provide meaningful input into the QIS process. If so, how can we implement these requirements without knowing how they will impact real banks and real portfolios? How can the regulators have confidence that the systems will be in place by the supposed implementation date? What if the data at that stage generates unexpected answers, as the credit risk numbers have done for QIS 4. What do we do then?

At today's hearing we will hear from a distinguished panel of regulators, including Federal Reserve Governor Susan Bies, Acting Comptroller of the Currency Julie Williams, FDIC Director Thomas J. Curry, and Acting Office of Thrift Supervision Director Richard M. Riccobono as well as a panel of private sector witnesses. I look forward to hearing from today's witnesses and thank them for taking time from their busy schedules to join us.

I am now pleased to recognize the Ranking Member, Mr. Sanders, for any opening statement that he would like to make.

For release on delivery
10:00 a.m. EDT
May 11, 2005

Statement of

Susan S. Bies

Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

and the

Subcommittee on Domestic and International Monetary Policy, Trade, and Technology

of the

Committee on Financial Services

U.S. House of Representatives

May 11, 2005

Chairman Bachus, Chairman Pryce, and members of the Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology: It is a pleasure to join my colleagues from the other banking agencies to discuss the current status of Basel II in this country, as well as the Federal Reserve's views on H.R. 1226. The continued discussion among the Congress and the regulators--and, of course, the banking industry and other members of the public--is critical to the final implementation of the new capital accord.

The focus of recent attention has been the agencies' announcement that they will delay the notice of proposed rulemaking (NPR) for Basel II, originally scheduled for midyear 2005. In my remarks today, I will discuss the reasons for the delay and the Board's views regarding the timetable for implementation of Basel II in this country. But, first, I believe it may be useful to remind the members of the subcommittees why the agencies thought it wise to explore and then develop a modernization of the current capital accord; those factors have become, if anything, more important than they were when we began the process.

Our banking system is becoming more concentrated, with a number of very large entities operating across multiple business lines and national boundaries, each entity with positions and exposures that are both complicated and difficult for third parties to understand. These entities have outgrown the current regulatory capital regime, which is still adequate for most banks. But the current rules simply cannot keep up with the complex business of the global banking organizations toward which Basel II and its infrastructure prerequisites are directed. These organizations represent significant risks to the financial system should they develop substantial problems in a period of stress. Basel II offers the opportunity to work with these large entities to develop quantitative risk-measurement and risk-management systems that can both measure their

risk more accurately and become the basis for more risk-focused capital requirements and prudential supervision. We would also require, as part of the Basel II approach, more public disclosures to improve market discipline and supplement supervisory efforts.

Many internationally active U.S. banks apparently agree that we should work toward Basel II. Indeed, we and the industry have already seen some benefits from work on Basel II implementation in that market participants and bank supervisors have developed a common language for inputs into risk-management processes.

Earlier this year, twenty-six banking organizations provided us with internal measures of credit risk as part of the fourth quantitative impact study, or QIS4. The agencies have now reviewed the risk parameter estimates provided and are discussing with individual participants their approaches to developing the required inputs. These discussions, which are ongoing, have significantly changed some of the data provided, and some modifications are still coming in.

Nonetheless, even with these revisions, two conclusions are already clear. First, the dispersion among the banks in their estimates of the key parameters that would be used to calculate Basel II capital requirements was quite wide--much wider than expected. Second, the implied reductions in minimum regulatory capital were often substantial--far more than previous quantitative impact studies, both here and abroad, had suggested. As responsible and prudent regulators, we believe it is appropriate to improve our understanding of these results and to see whether changes might be needed in our proposals.

From the outset of our participation in the development of Basel II, the U.S. agencies have clearly and consistently stated that the final adoption of the new capital rules in the United States would occur only after (1) we had reviewed all public comments and incorporated any needed adjustments to address legitimate concerns, and (2) we were satisfied that Basel II was

consistent with safe and sound banking in this country. Throughout this process we have stressed that, should we become concerned about the level of overall capital in the banking system or the capital results for individual portfolios, we would seek to modify the framework, including possibly recalibrating the regulatory capital formulas that translate an individual bank's risk parameters into required capital. The agencies' current review and study is consistent with our historical position at Basel.

All of the agencies want to have a better understanding of QIS4 data and results. Does the dispersion reflect different risk profiles? Different model assumptions? Different estimates of risk for the same kind of asset? Different kinds of internal rating systems with some looking "through the cycle" and others being "point in time"? Different stages of institutions' implementation efforts? Limitations of current data bases? Some other factor? We hope that further analysis and discussion with respondents can provide some answers to such questions. All the agencies believed that the prudent approach was to delay the NPR to gain better understanding of the reasons for the unexpected results.

Still, this decision presents the U.S. banking agencies with a dilemma. There is good reason to delay the NPR and related supervisory guidance, but those very documents are needed to provide more complete blueprints for what banks will need in terms of the databases and systems to implement Basel II. We are not saying that these large entities today have inadequate risk-management systems. Rather, they do not yet have the systems for producing Basel II inputs that meet the standards set forth in the Basel II proposal. Until the banking organizations have the NPR, many just will not be able to provide us the inputs we need to assess how banks would operate under Basel II. The dilemma can be solved only by first issuing the NPR. But, we must then have a prudent and flexible way to make adjustments should the resultant data

produce results that we, as supervisors, are not comfortable with. The plans developed before the delay in the NPR offer just such an opportunity.

Under those plans, institutions required or planning to move to Basel II would, after the adoption of a final rule, decide when to start their parallel run--with the first opportunity in January 2007. During the required parallel run, each bank would continue to calculate its required capital under the current capital regime and simultaneously calculate its Basel II capital statistics for review by its primary supervisor. When the supervisor believes that the bank has produced four quarters of credible Basel II estimates, the bank would be able to enter a minimum two-year transition run, the earliest in 2008 under these plans. During this transition run, the bank would be under Basel II capital rules, but it could not reduce its capital below 90 percent of what the current capital rules would require in the first year or below 80 percent in the second year. The length of either the parallel run or the transition run could be extended if the primary supervisor had doubts about the bank's Basel II system or the prudence of the resulting minimum regulatory capital level. Only after a minimum two-year transition run and only if its primary supervisor had no objection could a U.S. bank operate fully under Basel II capital rules.

This phase-in plan has been designed to ensure that bank inputs are reasonable and consistent with sound risk-management practices and that supervisors are comfortable with the safety and soundness of Basel II before it goes fully "live" in the United States. Please note that only when we get into the parallel run period will the agencies be able to accurately assess the aggregate capital effects as well as the effects on individual institutions from the new accord. Only then will banks' systems provide risk-parameter inputs that comport with the operational requirements of Basel II, and only then can the U.S. authorities be confident that the resultant capital calculations are reliable estimates of what will happen when Basel II is fully

implemented. Such data would be far superior to those obtained through the four QIS exercises that we have conducted to date, which, as I have noted, have been carried out by banks on a best-efforts basis using systems that do not yet meet the standards required under Basel II. Once we have data from the parallel run period, the agencies can then consider the need, if any, for a recalibration of the Basel II parameters or other actions to ensure more-accurate risk sensitivity and a prudent level of overall capital.

This deliberate process provides multiple safeguards to help the agencies move to the final adoption of the new framework in the United States *only* when doing so is clearly appropriate. In other words, our implementation strategy has been designed to be both prudent and flexible enough to move banks from Basel I to Basel II as their own systems mature and they can provide reasonably accurate assessments of their credit and operational risks. The agencies' analysis of and reaction to QIS4 results show how those safeguards work: We saw results that gave us concern, and so we are investigating further before we go to the next stage. Additional, future safeguards--such as the NPR process and the minimum one-year parallel run and the minimum two-year transition period, with options to extend either--will also ensure ample opportunity to recalibrate or seek other adjustments if necessary.

But, for now, we believe that after a certain point, further analysis of QIS4 is likely to reap little or no additional benefit. We should, of course, try to learn what we can from these data and particularly look for indications of the need to modify the Basel II proposal where necessary. However, as soon as we have learned what we can, we should promptly return to the development of the joint NPR and related supervisory guidance. These documents are essential so that core and opt-in banks can continue to develop the databases and systems that they would

need to operate under the Basel II capital rules and that would provide more-accurate risk parameter estimates than those in QIS4.

Recall that there have already been three rounds of U.S. public comments on the Basel II consultative papers between 1999 and 2004; an advance notice of proposed rulemaking (ANPR) in 2003; and numerous agency discussions with congressional committees, banking groups, and individual banks. All have resulted in significant modifications to the proposal. Once published, the NPR and the supervisory guidance will once more elicit comments that could result in further revisions. Particularly given its delayed issuance, the NPR must solicit feedback from core and potential opt-in banks as to whether the current timeline for implementing Basel II in this country needs to be delayed or can be retained.

Looking forward, I agree with my colleagues at this table that it is prudent to delay the NPR in order to see what we can learn from further review of QIS4 data, recognizing at the outset that final answers will not be forthcoming because the requisite databases and risk-management systems are not yet in place. I hope that we can return to the NPR before midyear, present it to the Office of Management and Budget for its review, as our OCC and OTS colleagues must do, and release the NPR in the fall. With such a schedule, one might hope that the parallel running period, currently scheduled for 2007, need not be delayed. But, as I noted earlier, it is important for the agencies to get feedback on this issue during the NPR comment period. The views of banking organizations will provide critical insights into the feasibility of the scheduled 2008 start date for the transition run. Once we have the views of the banking organizations, the agencies will be in a better position to reach a consensus on the timeline.

Basel II has the potential to be an important supervisory step forward. The Basel I framework is being arbitraged aggressively and provides us with less and less reliable measures

on which to base a regulatory capital requirement for our largest and most complex banking organizations. Moreover, banks have spent tens of millions of dollars preparing for the U.S. implementation of Basel II and have contracts for further investment. They are awaiting the NPR, the guidance, and the final rules. Their global competitors are proceeding, and U.S. banks will be eager to avoid being placed at a competitive disadvantage. I might add that, as supervisors, we believe that the core risk-measurement and risk-management improvements contained in Basel II are appropriate, regardless of how the future accord is finally structured and calibrated. So it is, in our view, a good idea for banks to continue their current trajectory of making risk-management investments.

While the regulatory capital requirements ultimately produced by Basel II would be, we believe, considerably more risk sensitive than the current capital regime, importantly this is not the only capital regulation under which U.S. institutions would operate. Over a decade ago, the Congress, as part of the Federal Deposit Insurance Corporation Improvement Act's Prompt Corrective Action (PCA) regime, defined a critically undercapitalized insured depository institution by reference to a minimum tangible-equity-to-asset requirement, a leverage ratio. The agencies have also used other leverage ratios to define other PCA capital categories because experience has suggested that there is no substitute for an adequate equity-to-asset ratio, especially for entities that face the moral hazard that accompanies the safety net. The Federal Deposit Insurance Corporation (FDIC), responsible to the Congress for the management of the critical deposit insurance portion of the safety net, has underlined the importance of that minimum leverage ratio and PCA as part of a prudent supervisory regime.

The Federal Reserve concurs in the FDIC's view. We need, for reasons I have given, the risk-measurement and risk-management infrastructure and risk sensitivity of Basel II; but we

also need the supplementary assurance of a minimum equity base. The market and the rating agencies will continue to require exactly that kind of base, and a regulatory minimum is prudentially desirable.

Even though the market and the rating agencies, not to mention bank management, will still require banking organizations to carry capital considerably above regulatory minimums, many of the thousands of depository institutions that will remain under the current capital rules are concerned about the impact of Basel II on their businesses. This concern is often voiced as a general disquiet about broad competitive feedbacks but also about competitive implications in specific markets. The Federal Reserve has published a series of research papers investigating such concerns voiced in public comments on the previous ANPR on Basel II. These studies have indeed suggested that there are potential effects that should be addressed in the small business and residential mortgage markets.

For this reason, as well as to continue to modernize the current capital regime, the agencies are developing, simultaneously with the Basel II proposal, a proposal to revise the current capital rules for non-Basel II banks to make those rules more risk sensitive and to blunt any unintended harm that Basel II might impose on non-adopters. Our intention is to keep these proposed changes simple to minimize any costs imposed on the many non-adopters. We plan to issue these proposals for public comment concurrently with or soon after the NPR on Basel II, to allow the banking community to comment on a combined package of proposed changes. However, these revised Basel I rules would not be an adequate substitute for the necessary capital reforms for the large, complex, global banks operating in this country because they would not provide the incentives for banks to adopt the more-sophisticated risk-measurement and risk-management techniques envisioned by the Basel II proposal.

Chairman Bachus and Chairman Pryce, I would also like to present the Federal Reserve's views on H.R. 1226, a bill setting up a committee of the four banking and thrift regulators to reach a common U.S. position on Basel issues and authorizing the Secretary of the Treasury, as its chairman, to determine a common position on any issue about which the regulators could not agree. The Federal Reserve believes that the bill does not fully reflect the existing process used by the four agencies to develop and modify Basel II and we would counsel that Congress not enact it.

Staff members of the four agencies have held frequent and comprehensive discussions about Basel II throughout the process. Certainly, the agencies have sometimes disagreed on specific issues, and we will sometimes disagree in the future. But we have in the past been able to find a common position that we can all support at Basel, and we will do so in the future. The salient fact is that any one of us has a veto over the entire proposal because we all realize that different rules cannot be applied to similarly situated insured depository institutions. That fact forces us to develop consensus positions on which all of us can agree. We have done so in the past because we understand that if the agencies cannot reach a collective agreement at Basel, the Basel II reforms will not be implemented in the United States while they go forward in the rest of the world. Communication, compromise, and comity are the prerequisites for agreement among the agencies.

Further, the ability of the U.S. agencies to negotiate effectively at Basel would be severely constrained if our foreign counterparties knew that we had to return to a committee before we could agree. The formalized "decision by committee" approach of H.R. 1226 would not advance U.S. interests in the complex and dynamic Basel negotiation process. The U.S. banking agencies need to preserve our current flexibility to respond to Basel issues if we are to

develop a set of capital rules that are useful and productive for U.S. banks and thrifts. Moreover, it is possible that the agencies are more likely to implement effectively an agreement that they helped shape than they would be one that was imposed on them and for which they did not understand fully the rationale. While we urge the Congress not to move forward on this bill, we look forward to keeping Congress fully informed as the Basel process continues.

I will be pleased to answer your questions.

The Potential Competitive Impacts of Basel II in the U.S. Market for Residential Mortgages

Statement before the U.S. House of Representatives Subcommittees on Financial Institutions and Consumer Credit and on Domestic and International Monetary Policy

by

Paul S. Calem, Ph.D.

and

James R. Follain, Ph.D.

May 11, 2005

My name is James Follain. I am currently the SVP of Mortgage Valuation for Fidelity Hansen Quality. I have a Ph.D. in economics and have spent nearly 30 years as an economist specializing in the housing and mortgage markets. My comments this morning are based upon work done jointly with Dr. Paul Calem who is a VP for Loan Performance. Previously, Dr. Calem spent 20 years as an economist at the Federal Reserve Bank of Philadelphia and the Federal Reserve Board and studied many aspects of the banking industry. Paul and I appreciate the opportunity to share our views with you.

I. Introduction

In June of 2004, the Basel Committee on Banking Supervision published the outcome of its work over the past several years to produce significantly more risk-sensitive regulatory minimum capital requirements for internationally active banks.[1] The new agreement is an update of the 1988 Accord (Basel I) and is widely referred to as the Basel II Accord. The most advanced set of rules that define minimum capital requirements under Basel II, called the Advanced Internal Ratings Based (AIRB) approach, places substantial reliance upon banks' internal data and risk measurement and management processes.[2]

Now that the principles of Basel II have been agreed to internationally, regulators in each participating country are now focused more fully upon their respective implementation plans. In determining how broadly the new rules should be applied in the

[1] See Basel Committee on Banking Supervision BIS (2004).
[2] Two alternative sets of rules – the Foundation approach and the Standardized approach – incorporate more risk sensitivity than Basel II but stop short of the variations in risk sensitivity of capital requirements associated with the AIRB approach

U.S., regulators face a tradeoff between the explicit costs of implementation across a broad spectrum of banking organizations and the benefits of widespread adoption of a more risk-sensitive system of regulatory capital requirements. In addition, regulators must factor into their calculations a potentially substantial, implicit cost of a narrower implementation plan -- the potential to alter the existing competitive landscape among U.S. banking organizations in the market for residential mortgages. This topic is the focus of our paper.

At one end of the range of implementation possibilities is a plan that requires full-implementation of the AIRB approach for all banking organizations. This would almost surely impose an unjustifiable burden for many smaller banking organizations and bank regulators. At the other end is a bifurcated plan in which only the largest internationally active banking organizations would be required to implement the AIRB approach (adopters). This would impose little or no explicit costs on nonadopters, but it has the potential to generate less explicit costs that may arise from the impact of a bifurcated implementation upon the competitive landscape between adopters and nonadopters. Of course, variants between these two limits are possible.

U.S. regulators have, in fact, proposed a system closer to the latter. The plan calls for ten or so of the largest banking organizations to be required to adopt the AIRB approach. Though a small number may choose to apply for AIRB status (opt-in candidates), all of the other 8,000 or so banking and thrift organizations would continue to operate under Basel I rules. Hence, limiting the implementation to only the largest organizations attains some of the intended benefits of Basel II – greater risk sensitivity of

capital requirements for some large banking organizations – while avoiding the imposition of any substantial costs (explicit or implicit) upon nonadopters.

When this implementation plan was originally proposed, regulators expressed a belief that the competitive effects within the U.S. are unlikely to be significant due to changes in regulatory capital requirements.[3] A recent study by the Federal Reserve Board also concluded that the potential competitive effects for the case of residential mortgages will be small.[4]

Our best reading of the evidence available leads us to offer an alternative view regarding the quantitative impact of the proposed implementation plan in the market for residential mortgages. In brief, the cost of investing in such mortgages will be lower for adopters than nonadopters, which will permit them to offer lower interest rates to consumers and to gain market share at the expense of nonadopters. Nonadopters that specialize in holding residential mortgages will be especially impacted by the proposed plan.[5]

The economic rationale underlying our view is actually quite simple. Adopters will gain a cost advantage relative to nonadopters for some categories of mortgages with relatively low amounts of risk because Basel II will greatly reduce the regulatory capital requirements for these residential mortgages. Given what we believe to be a highly

[3] See, for example, Ferguson (2003).
[4] See Hancock, et al. (2005).
[5] Our attention is focused primarily upon competition among banking and savings organizations subject to Basel II. The current role of the two large government-sponsored enterprises (GSEs) – Fannie Mae and Freddie Mac – and the potential impacts of heightened competition for residential mortgages between them and the adopters are discussed, but they are not deemed central to the decision facing the regulators about Basel II unless bank regulators place a benefit on a reduced size of the GSEs as a benefit of Basel II. Frame and White (2004) and Hancock, et al (2005) discuss this aspect.

competitive market among banking organizations for residential mortgages, business will eventually shift to the low cost provides of these mortgages.

A difficult and challenging for all analysts of this issue is the precise measurement of the likely change in the distribution of mortgage investments between adopters and nonadopters. One reason stems from the lack of detailed information available to either the public or the regulators (e.g. Call Report data) on the $2.3 trillion holdings of 1-4 family residential mortgages by U.S. banking organizations. Another is the complexity of the residential mortgage market and, especially the complex ways in which it is affected by securitization. Here, we offer an analysis designed to articulate and validate as best we can a view that the proposed bifurcated regulatory capital system may have significant competitive effects in the case of residential mortgages.

Our presentation begins with some background information about the market for residential mortgages and Basel II's treatment of mortgages (Section II). The third section presents the assumptions underlying our calculations; our specific estimates of the amount of business that may be lost by nonadopters are presented in Section IV. The final section offers a brief summary and suggestions to minimize the impacts while ensuring gains to consumers and the broader goals of Basel II.

II. *Key Assumptions*

The arguments presented in this paper rest upon a number of assumptions and perspectives about the role of capital in the residential mortgage market, the computation of regulatory capital for AIRB adopters, and the relative importance of regulatory capital in bank investment decisions. We seek to explain some of the requisite background information in this section.

A. *Capital costs can be a substantial component of the cost of mortgage investing*

The annualized cost of holding a residential mortgage consists of three major components (see, for example, Posner 2002).[6] The most substantial component is the cost of debt financing of the mortgage. In the case of banks, this component is typically approximated by the cost of deposits. The second component is the cost of originating and servicing the mortgage; these are largely operating costs and the cost of requisite infrastructure. The third is the cost of the credit and interest rate risk associated with mortgage investments.

Both credit and interest rate risk stem from the options available to borrowers. Credit risk arises from the put option available to borrowers and interest rate risk (including both spread and prepayment risk) from the call option available to them.[7] Investors demand a premium for assuming these risks, which can be expressed as the sum of two components: expected costs and the cost of capital. In the case of credit risk, expected costs refer to expected or average credit losses due to default. In the case of interest rate risk, expected costs refer to the ongoing costs of hedging activities designed to meet minimum duration and convexity targets.

Our focus is upon the capital cost associated with credit and interest rate risks because it is only capital costs that are directly impacted by Basel II. We define capital costs (C) as the annualized cost of equity capital set aside to insure against unexpected or extreme losses; that is, $C = i_e (K_c + K_i)$, where i_e is the price of equity capital, K_c is the

[6] Posner (2002) presents a comprehensive look at variations in the cost components of mortgage investments.
[7] An enormous literature exists to explain and measure these option-based approaches.

capital set aside to insure against unexpected credit losses and K_i is the amount set aside for unexpected losses due to interest rate risk. The amounts of capital that banks would allocate internally; that is, in the absence of regulatory intervention, to cover losses in an extreme or highly unlikely outcome are known as economic capital.[8] Economic capital need not coincide with the capital allocated to meet regulatory requirements. Within the present context, our focus is upon the relationship between the regulatory environment and the two capital terms, since we do not expect Basel II to have a substantive impact upon i_e.

The amount of economic capital for each of these risks varies widely among loans. For example, there is general agreement that a portfolio of prime fixed rate mortgages is exposed to substantially greater risk than a portfolio of prime adjustable rate mortgages. Smaller loans and loans with higher loan-to-value ratios also tend to be associated with lower interest rate risk. Clearly, there is wide variation in economic capital for credit risk among mortgages that differ with the borrower's credit rating (FICO score) and the original loan-to-value ratio (LTV) of the loan. For example, Calem and Follain (2003) calculate that the economic capital needed for the credit risk of a "risky" loan (620 FICO, 95 percent LTV) is over 20 times that for a "safe" loan (740 FICO, 70 percent LTV). In addition, economic capital needed for credit risk is substantially higher for banking organizations with more geographically concentrated mortgage loan portfolios.[9]

[8] In other words, economic capital is chosen to meet a certain risk tolerance or probability of bankruptcy.
[9] Economic capital for a portfolio with whole loans from a wide variety of regions – nationally diversified – is lower than is economic capital for a portfolio of similar risk characteristics from a single region – regionally concentrated.

To demonstrate the empirical significance of capital costs, consider the case of the standard mortgaged-backed security (MBS) issues by one of the two government-sponsored agencies (GSEs) in the secondary mortgage market, Fannie Mae or Freddie Mac. The GSE typically purchases loans from one or more originators and then packages them into an MBS. The originator receives the sale price of the loans and is largely out of the picture, although some may retain servicing or choose to purchase the MBS via a swap program. A portion of the cash flows from the mortgages goes to a servicing institution which is paid a servicing fee. The MBS is sold to an investor. The GSE retains the credit risk on the pool of mortgages (that is, it provides a credit guarantee, exclusive of the portion that is assigned to mortgage insurers, if applicable) and it receives a "guarantee fee" in return. The interest rate risk is transferred to the investor who purchases the MBS, who in turn receives coupon payments. In essence, this particular securitization process involves the sale of credit risk protection or a credit guarantee to the investors in the MBS in exchange for a guarantee fee.[10]

A simple example demonstrates the importance of capital costs to this particular investment type.[11] The gross guarantee fee charged by the GSEs for MBS backed by prime or high quality loans is currently in the range of 15-20 basis points. Assume that operating costs for this program are 5 bps, a cost of equity capital of 15 percent, and a

[10] Entities other than the GSEs -- including large banking organizations, the Federal Home Loan Bank system, and nonbanks -- also issue securities that transfer unbundled credit risk for pools of nonconforming mortgages. The Federal Home Loan Bank (FHLB) MPF program is an example discussed by Frame (2003), Frame and White (2004), and Van Order (2000). Under this program, a participating bank or thrift sells its loans to an FHLB and retains a second, or mezzanine, loss position. The FHLB holds a first loss and a catastrophic loss position. All of the interest rate risk is owned by the FHLB.

[11] The significance of these capital costs also depends upon the particular form of mortgage investment undertaken by an investor. Some may choose to invest in all aspects of the mortgages, but the practice of "unbundling" is the norm rather than the rule among mortgage investments. Unbundling refers to the ability of investors to focus their mortgage investments on one or more aspects of the income and risk associated with such mortgages. For example, some may focus upon the servicing income. Some may focus on the interest rate risk associated with mortgages and jettison both the risks and rewards associated with credit risk and servicing.

ratio of tail loses to expected losses of four (K_c/EL = 4); *then capital costs comprise 37.5 percent of total credit costs and 25 percent of total costs.*[12]

B. *Basel II will reduce regulatory capital requirements for mortgages*[13]

The existing Basel I capital requirements set two basic sets of information. The first is the total amount of capital required by the banking organization and the second is a set of risk-weights that vary among assets and are used to define total risk-weighted assets of the bank. Tier 1 capital is set at 4 percent of risk-weighted assets; total capital is set at 8 percent of risk-weighted assets. Risk-weights are stated relative to a 100 percent risk-weight. Residential mortgages ("prudently underwritten") have a 50 percent risk-weight and hence require 200 basis points of Tier 1 capital (200 = 0.50*400) and 400 basis points of total capital. Other assets have higher or lower risk-weights.

Separately, U.S. banks are subject to a set of "leverage" requirements (not part of the Basel Accord) that define required capital in terms of non-risk-adjusted assets. These vary by the rating a bank requires in order to achieve one of several categories of adequate capitalization. For example, a well-capitalized banking organization has at least total capital in excess of 10 percent and Tier 1 capital in excess of 5 percent. "Adequately capitalized" ratios are 8 and 4 percent, respectively. Although it is typical for Basel I capital requirements to exceed the leverage requirements for a bank involved in the full spectrum of credit risk, this is not always the case. Indeed, this situation is

[12] Define the guarantee fee as: $g = EL + G\&A + i_e K_c$. Assume $K_c = 4EL$, then $i_e K_c/g = .25$ if G&A = 5 and $i_e = .0.15$.

[13] Pillar II pertains to additional capital requirements that can be imposed by bank regulators during the supervisory process. Pillar III refers to the use of public disclosure. More information can be found at: http://www.federalreserve.gov/generalinfo/basel2/default.htm.

likely to be potentially important to mortgage lending specialists and it receives special attention below.

As discussed by Calem and Follain (2003), the AIRB approach will generate substantial reductions in the minimum regulatory capital requirements for most residential mortgages. Examples of the Tier 1 minimum capital requirements are contained in Table II-1. The last row provides an estimate of the amount of Tier 1 capital that would be required for an adopter with an average portfolio of high quality mortgages that are well-diversified geographically. *The amount is 40 basis points, which is one fifth of the 200 bps that would be required by nonadopters, all else equal.* For some risk segments the difference is larger and for some others it is smaller.

C. *How regulatory capital rules can impact bank investment decisions*

We have now established how capital costs can influence the cost of mortgage investing and that Basel II will generate a substantial disparity in regulatory capital costs for typical mortgage investments between adopters and nonadopters. A remaining issue is whether banks' capital assignments and investment decisions for particular products are much or at all influenced by regulatory capital for those products. Alternatively stated, we wish to know whether regulatory capital rules are *binding*; that is, do they influence the investment decisions of banking organizations. If not, then a disparity in regulatory capital treatment would have no competitive impact. If so, then some competitive effects are possible via the process known as of regulatory arbitrage.[14]

[14] Indeed, the process can be viewed as an example of the concept of the "regulatory dialectic", which was coined by Kane (1981) and is regularly cited in the banking literature as a concept to describe the "cat and mouse" game between banking organizations and their regulators. Recent examples with numerous references to his work are Kovakimian and Kane (2000) and Cabral dos Santos (1996).

Regulatory capital arbitrage is a shift in a particular line of banking business from the participant with a higher and binding regulatory capital requirement for this line of business to a participant with a lower capital requirement. In particular, a binding capital rule can lead to "the perverse result (is) that banks actually face incentives to hold riskier assets within each category" (See Emmons et. al, 2005).

The theoretical foundations of the concept of regulatory arbitrage are well established in the literature.[15] For example, Calem and Rob (1999) develop a model where a binding regulatory capital floor implies a shift in the composition of the loan portfolio toward riskier assets.[16] Van Order (2000) discusses the concept of regulatory capital arbitrage specifically in relation to mortgage portfolios and competition between banks and nonbanks. Frame and White (2004) discuss how Basel II bank regulatory capital may affect the competition between the GSEs and adopting banks. Below, we apply an analytical framework that is similar to but more specific than that of Frame and White and that highlights the potential transfers within the banking industry. The intuition behind all of these results is that profitability increases with leverage, with the amount of leverage determined by the inverse of the economic capital ratio.

Clearly, for Basel II to induce regulatory capital arbitrage in the form of mortgage investments shifting from non-adopters to adopters, it must be the case that current regulatory requirements are binding for banks at the aggregate institution level and on at least some categories of mortgage investments in particular. Empirically, the extent to

[15] There is a substantial theoretical literature on the relationship between capital regulation and bank risk taking. The literature generally suggests that banks will increase portfolio risk in response to a binding regulatory capital requirement. Under special conditions, this relationship need not hold; for instance, if relative risk weights under the regulatory standard align with relative economic capital as in Rochet (1992). See Allen (2004) for a review of this literature.

which regulatory capital rules are binding and induce arbitrage is difficult to evaluate, but a sense that they have distorted bank risk-taking incentives was a significant factor motivating Basel II reforms. For instance, Jones (2000) argues that Basel I resulted in a shift in certain types of investments from banking organizations to nonbanking organizations not bound by Basel I rules. He cites securitization and, specifically, the emergence of the market for CDO securities (collateralized debt obligations) shifted certain business loans from banking organizations to a wider variety of investors.

As already noted, for most residential mortgages, economic capital for credit risk is much less than currently required regulatory minimum capital. Therefore, one may reasonably conclude that total economic capital typically is less than regulatory capital in the case of mortgages characterized by relatively little interest rate risk, such as adjustable-rate loans or smaller loans. For further evidence, we offer a brief case study of the markets for credit risk and interest rate risk among conforming, conventional mortgages (loans eligible for purchase by the GSEs and not government-insured) as highly suggestive of an impact of binding regulatory capital rules on the distribution of these risks. The case demonstrates a close linkage between the market shares of the two GSEs and existing regulatory capital differences for the GSEs and banking organizations.

A widely accepted stylized fact is that the bulk of prime, fixed-rate conforming, conventional mortgages are held in the form of GSE MBS and with the attached GSE credit guaranty.[17] This GSE dominance in the market for credit risk of these mortgages is consistent with the hypothesis that regulatory capital can have substantial impacts. In

[17]Data to measure the size of the conventional, conforming market and the GSE are not available owing, especially to the difficulty of measuring loans that satisfy the evolving GSE underwriting criteria. Nonetheless, we are confident that most would agree with our estimate for what we have in mind -- conventional, prime fixed-rate mortgages, which have been the focus of GSE securitization for many years.

particular, the GSEs enjoy a much lower regulatory minimum capital requirement than do banking organizations for the credit risk on this class of mortgages. GSE capital rules require 45 basis points of equity capital for bearing the credit risk associated with their outstanding MBS (whether the MBS are held in their own portfolios or held by others). The comparable concept for banks is the Basel I Tier 1 minimum capital requirement for banking organizations which is 200 basis points. Thus, the GSEs have a large regulatory capital advantage for credit risk and dominate this particular market.

Clearly, the regulatory capital advantage is not the only possible source of GSE dominance in this area. Indeed, to be truly binding on a particular category of mortgage assets, the regulatory capital requirement must exceed the sum of economic capital for both interest rate and credit risk, and this will not necessarily be the case for all conforming mortgage categories. Moreover, other factors, such as economies of scale or historical advantages may contribute to the GSE dominance. Nonetheless, we find the regulatory capital considerations to be quite compelling.

In contrast, the GSEs are much less dominant in the market for the interest rate risk associated with conforming, conventional mortgages. This is measured by the distribution of the holdings of the GSE MBS, since these involve interest rate risk and no credit risk to the investor. The GSEs held about $950 billion of the $3 trillion (in outstanding GSE MBS at the end of 2003 (OFHEO, 2004), which is a 31 percent share. The rest were held by banks, thrifts, insurance companies, and other investors. Banks and thrifts held about $960 billion of MBS and collateralized-mortgage obligations backed by the GSEs and GNMA at the end of 2003.[18] So even allowing that some of the $960

[18] This information was obtained from the FDIC's web site: http://www2.fdic.gov/sdi/main.asp.

billion in bank holdings of MBS are GNMA securities, the distribution of this particular form of investment is much more equally distributed than is the investment in the credit risk associated with conventional conforming market.

This stylized fact is also consistent with the differential regulatory capital charges levied on banks versus the GSEs. The implicit charge for bearing the interest rate risk on an MBS held in its portfolio is 205 basis points of regulatory capital, which is higher than the 80 basis points of Tier 1 capital required of banks.[19]

Also noteworthy is that banking organizations retain only about 20 percent of their originations with size below the conforming loan limits and about 50 percent of other mortgage originations (based on analysis of Home Mortgage Disclosure Act data). This fact is consistent with a regulatory arbitrage motivation for sale of conforming loans to the GSEs, and also suggests that there presently are fewer opportunities for regulatory arbitrage by banks in the nonconforming loan market.[20]

In sum, the stylized facts in the markets for the credit and interest rate risk on conventional, conforming mortgages are consistent with the notion that differences in

---

[19] A GSE must also hold 250 basis points for a prime MBS held in a GSE portfolio. Since 45 basis points is associated with the credit risk guarantee associated with all of its MBS whether held in portfolio or not, the implicit minimum regulatory capital charge for bearing the interest rate risk of the MBS held in portfolio is 205 basis points (250 -45). In contrast, for a banking organization, 80 basis points of tier 1 capital (corresponding to a 20 percent risk weight) would be required for holding a GSE MBS (assuming other regulatory capital requirements, including the leverage requirement, are met). Thus, under Basel I, banking organizations face a *lower* marginal regulatory minimum capital charge for holding either an MBS (80 basis points per dollar of outstanding balance of the MBS) or a whole, prime loan (200 basis points) than the GSEs' regulatory capital charge for holding an MBS (250 basis points).

[20] One reason is that the costs associated with capital arbitrage transactions with GSEs are smaller than those associated with other nonbanks, due, for instance, to economies of scale, established channels or relationships between individual banks and the GSEs. Another reason is that both banks and the GSEs may have cost of debt or informational advantages relative to other nonbanks. A fundamental premise of our analysis is that regulatory capital arbitrage between adopters and nonadopters under Basel II will be less costly than is currently the case between banks and nonbanks other than the GSEs. Reasons why we expect this to be the case include the existence of established origination networks of adopters and of correspondence networks between nonadopters and adopters, and a relatively level playing field with respect to the cost of debt and information. We note disagreement between ourselves and Hancock, et al. (2005) on this premise.

regulatory capital rules can contribute to substantial differences in the distribution of these risks among potential investors. Alternatively stated, the differences in regulatory capital rules appear to be binding, leading to regulatory arbitrage and contributing to substantial differences in the investment decisions of the GSEs and banking organizations. We believe they are strongly suggestive about how Basel II and its bifurcated implementation may affect the competitive landscape for mortgages. Specifically, the lower regulatory capital rules available to adopting banks will provide them with an opportunity to dominate nonadopting banks in the market for credit risk protection on nonconforming mortgages in much the same way that the GSEs dominate banks in today's environment.

III. Measuring the Potential Impact of a Bifurcated Approach

The purpose of this section is to specify more precisely how a bifurcated implementation of Basel II is, in our view, likely to impact the competitive landscape for mortgages among banking organizations. A change in the competitive landscape is possible because the regulatory capital requirements for residential mortgages will be significantly lower for those who adopt the AIRB capital rules (adopters) versus those who do not (nonadopters) The differences may set in motion a regulatory arbitrage process in which the adopters will increase their share of investments in residential mortgages relative to nonadopters.

We propose two cases (scenarios or channels) in which adopters may gain at the expense of nonadopters in the mortgage market by virtue of the bifurcated approach. Both are premised on the prediction that Basel II will reduce the cost to adopter banking organizations of bearing the credit risk of high-quality residential mortgages.

In the first case, *whole loan transfer (case 1)*, adopters would be able to acquire for their own portfolios a larger fraction of mortgage originations relative to nonadopters. Alternatively stated, case 1 predicts that adopters will end up holding more of both the interest rate and credit risk associated with residential mortgages relative to nonadopters. The second case, *transfer of only credit risk (case 2)*, posits that a significant share of investment in *only* the credit risk of mortgages would shift to adopting banking organizations from nonadopters. The unbundling of interest rate and credit risk implied in this case might be done in any number of ways that include GSE like securitization or simply the purchase of credit guarantees or protection by nonadopters from adopters. Although this case will likely involve some effect on competition between adopter banking organizations and the GSEs, our emphasis is upon competition among banking organizations for types of mortgages that currently are commonly held in bank portfolios. That is, we focus is on competition among banking organizations for adjustable rate mortgages and *nonconforming* mortgages.

A. *Case 1: whole loan transfer*

This case predicts that adopting banks will hold relatively more residential mortgage debt (more whole loans) than nonadopting banks under the bifurcated approach. That is, some whole loans will be transferred from nonadopters to adopters over some period of time.

Theoretical models of regulatory capital arbitrage offer a motivation for this prediction. Adopters can be viewed as banks in which the new regulatory capital rules would not be binding; that is, the AIRB rules reflect economic capital. Nonadopters, however, will continue to operate in an environment in which the regulatory rule is

binding for at least some mortgages. Hence, regulatory capital arbitrage would lead to a shift in holdings of lower-risk mortgages to adopters from nonadopters, all else equal.

A more precise statement of case one requires a definition of the cost of financing an investment in a mortgage. The cost of financing per dollar of mortgage debt then can be written as:

$C = i_d (1-K) + i_e K + EL + GA;$

where C is the marginal cost of investing in a new residential mortgage; K again denotes the amount of capital for the mortgage, i_d is the cost of debt financing; i_e is the cost of equity financing; EL represents expected credit losses; and GA represents general administrative expenses. The mortgage coupon rate earned on the mortgage less this cost of financing represents the spread income earned by the bank. Higher amounts of capital reduce the riskiness of the investment to the bank and reduce the spread income earned on the investment.[21]

For a bank that is unconstrained by regulatory capital rules, which we assume would be the case for adopters under Basel II, $K = K_e$, the amount of economic capital for the mortgage. For non-adopters, the capital requirement (K_{na}) for a particular mortgage type will be the maximum of economic and regulatory capital; that is, $K_{na} = \max (K_e, K_r)$. So, for example, if the sum of economic capital for interest rate and credit risk for the mortgage is less than the regulatory requirement of 400 basis points, K_{na} equals 400 basis points.[22]

[21] Other ways of reducing the risk of this investment such as options could be included as capital substitutes; we simply assume that the bank chooses the least costly way of hitting its risk tolerance targets with capital or capital substitutes.
[22] Similarly, the amount of Tier 1 capital required by nonadopters would be 200 bps in this case.

The advantage to the adopter versus the nonadopters is the difference in their cost of financing the same mortgage. Holding everything else the same except for the amount of capital held by adopters under Basel II produces the following expression of the difference in the cost of financing for the case in which the regulatory capital amount is binding:

$\Delta C = C_{na} - C_a = \text{Max}[0, (i_e - i_d)(K_{na} - K_e)] = \text{Max}[0,(i_e - i_d)(K_r - K_c - K_i)] > 0.$

The last term highlights an important point; that is, the size of the regulatory advantage depends upon the amount of both interest rate and credit risk in the mortgage.

The cost difference varies significantly among products because of variations in the economic capital for both interest rate and credit risk. Several examples are provided to illustrate this point (see Table III-1). The first three pertain to the same 30 year fixed-rate mortgage (FRM) but with three different assumptions regarding its interest rate risk. In all three cases, the duration of the mortgage is 3.5, which is consistent with the change in the value of this type of mortgage for a 200 bps increase in the level of interest rates.[23] The first of these three cases assumes the mortgage is financed with a liability with duration of 1 while the second is financed with liability duration equal to 3. The third of these examples simply assumes that interest rate risk capital equals 160 bps (total capital requirement), which is the amount of regulatory capital for a GSE issued MBS.[24] The other examples pertain to adjustable-rate mortgages with various types of indexes. For these, interest rate risk capital is set equal to the maximum of a duration based calculation

[23] See OTS web site for these two tables: http://www.ots.treas.gov/pagehtml.cfm?catNumber=10

[24] We also point out that this amount of capital is below but near the regulatory capital required of the GSEs for their MBS investments (205 bps).

or 160 bps. Other assumptions include: i_e = 1250 bps; i_d = 250 bps; K_c = 100 bps; regulatory capital = 400 bps; EL + GA = 20 bps.[25]

Two main conclusions emerge from these examples. First, adopters have an advantage under certain plausible assumptions in the cost of financing a mortgage investment relative to nonadopters. The advantage ranges from 0 to about 15 bps or 5 percent of the cost of financing to nonadopters under Basel I for the product categories and our assumptions underlying Table III-1. Second, these examples highlight the critical role of capital for interest rate risk in determining the size of the advantage to the adopters. In the first two examples, Basel I is not a binding constraint for nonadopters due to the large amount of economic capital allocated to interest rate risk; therefore, adopters have no advantage. The lower the amount of capital for interest rate risk, the larger the potential gain to adopters, all else equal.

B. *Case 2: credit risk transfer*

As noted in Section II, unbundling of credit risk from interest rate risk is commonplace in today's mortgage markets--the classic example is the GSE MBS, which allows banks to retain all of the interest rate risk on a pool of mortgages and transfer (for a price) all of the credit risk to the GSEs. Because the credit risk of residential mortgages can be unbundled, the holder of the mortgage may be viewed as having a derived demand for credit risk protection.

[25] We do not include an explicit cost of transferring the mortgage. They are likely to be quite small at this point, although we do in the case our discussion of newly originated loans, Case 2. We could include such costs at this point as well even though they are not essential to Case 1. They are also likely to be quite small given the extensive network of mortgage brokers who may simply end up selling more loans to the adopters and bypassing nonadopters more frequently, and possibly even in the case of seasoned loans, given the existence of established correspondent networks between large and small banks.

The provider of credit risk protection must bear administrative expenses, expected losses, and the cost of holding a certain amount of capital (economic or regulatory) for this risk. The gross cost per unit of mortgage debt, G borne by the supplier of credit risk protection (which would be reflected in the guarantee fee that is charged) may be expressed as the sum of three cost components:

$G = EL + GA + i_e K.$

As with the cost of financing in case 1, the critical ingredient in our analysis of case 2 is the *marginal* amount of capital associated with such an investment (K_{na}). For the nonadopters, this depends upon the regulatory amount (K_r) and the amounts of economic capital for interest rate risk (K_i) and credit risk (K_c). Specifically, the amount of additional capital held by nonadopters for the *credit risk* of an additional mortgage is the maximum of two terms. The first of these terms is the additional amount of economic capital associated with the credit risk. The second term is additional amount of regulatory capital to the nonadopters, which is the difference between the Basel I regulatory rule for a mortgage and the amount of economic capital the bank would hold for interest rate risk. Thus, the marginal amount of capital to the nonadopters is: $K_{na} = \max (K_c, K_r - K_i)$.

If the Basel I rule is not binding for nonadopters $(K_c + K_i) > K_r$, then the adopters (whose additional capital for credit risk capital equals K_c) have no cost advantage due to Basel I. If it is binding, then the difference in costs can be written as:

$\Delta G = G_{na} - G_a = i_e (K_r - K_c - K_i) > 0$. Only the cost of equity matters in this calculation since the transfer is an off-balance sheet activity that involves no debt finance. Thus, comparison to the expression for ΔC, the cost differential in Case 1, reveals that $\Delta G > \Delta C$, which suggests that credit risk transfer would take precedence over whole loan

transfer if Basel I is binding. However, at least for newly originated loans, unbundling may be more costly than whole loan transfer. Whereas the latter might simply occur through the actions of consumers or mortgage brokers choosing one originator over another or via established correspondent networks between banks, in the case of nonconforming loans (which comprise most of the loans traditionally retained in bank portfolios) unbundling may involve significant search and transactions costs among multiple parties (for example, originator, investment bank, rating agency, buyer of the security).[26] Thus, Case 2 would dominate Case 1 only if $\Delta G - C_{ub} > \Delta C$, where the term C_{ub} denotes the cost of unbundling.

As with Case 1, several examples are presented to provide a sense of the size of the advantage to the adopters for the same set of products and assumptions (see Table III-2). No advantage exists in the fixed-rate mortgage examples with substantial interest rate risk; in fact, the advantage is negative because we include a cost for the unbundling itself (we assume 2 basis points). Otherwise, the pattern is the same as in Case 1. The smaller the amount of capital for interest rate risk, the larger the advantage to the adopters. The percentage differences are, of course, much more pronounced than in Case 1 because the numerator is about the same size as in Case 1 but the typical guarantee fee is only 10 percent or so of the cost of financing the entire mortgage.

What kinds of mechanisms are available to bring about the transfers in Case 2? There are a number of possibilities. The simplest would involve an unsecuritized and straight forward credit guarantee in which the adopters would receive payments from the nonadopters in exchange for a guarantee of losses. Securitized options are possible as

[26] IN contrast, economies of scale and direct channels from originators may allow the GSEs to accomplish unbundling at relatively low cost

well. Something like the GSE credit guarantee is an obvious one. For example, one of the adopters would buy loans from nonadopters and issue an MBS with their credit guarantee. Many more elaborate securitization approaches are possible.[27]

Does the particular type of mechanism or process for the credit transfer affect the essence of our story? We think not. The degree to which a particular mechanism is preferred, as with the degree to which Case 1 would prevail over Case 2, would relate to the cost of unbundling.

Another possibility is that the optimal mechanism will be affected by another portion of the Basle II agreement we do not explicitly consider; these are the Basel II rules that pertain to capital requirements for securitization. Our reading of Basel II suggests this is a second order issue because of the guiding principle underlying the development of Basel II capital rules that affect securitization. In particular, the principle is to make banking organizations neutral with respect to either holding loans or holding securities based upon the loans.[28] To the extent this principle is achieved by the Basel II securitization rules, they will not affect our basic argument – adopters will have a cost advantage in case 2. The biggest impact of the securitization rules is likely to be their influence upon the broader choice between securitization and direct credit guarantees, although we agree that this issue is complex and worthy of more study.

---

[27] The MODERNS security issued by Freddie Mac is one example; see Glenn (1999). A more general approach is labeled as a synthetic security and includes some done by Bank of America for the specific purpose of transferring credit risk on mortgages between two or more parties.

[28] See paragraph BIS(2004), paragraph 610, which states that: "For a bank using the IRB approach to securitisation, the maximum capital requirement for the securitisation exposures it holds is equal to the IRB capital requirement that would have been assessed against the underlying exposures had they not been securitised ...."

IV. The Aggregate Size of the Transfer

Now we address a more difficult but important question: is the potential aggregate impact likely to be materially significant? As noted above, it appears that the regulators originally may have underestimated the competitive costs of the proposed plan within the mortgage market. If so, then a finding of a sizeable or substantial potential aggregate impact in the market for mortgages may lead the regulators to revise the implementation plan to address these concerns.

It is not our aim to provide precise, quantitative predictions regarding the competitive impact of Basel I, in our view is rather impossible task. Rather we offer a rough or illustrative assessment of the likely impact, based on available information and what we consider to be plausible assumptions. Our strategy is to infer as best we can from the current composition of banking organization portfolios how the observed distribution of mortgage investments between adopters and nonadopters would differ if this distinction were already well established. In reality, of course, any such redistribution resulting from Basel II would involve a process of adjustment over time, and nonadopters could seek to regain lost income from mortgage investments through other activities. We abstract from these considerations.

The previous section provided some sense of the potential cost advantage to adopters under Basel II for various categories of mortgages classified by interest rate and credit risk. Our assessment of the potential aggregate impact requires two additional types of information. The first we refer to as the elasticity of the demand for the asset (ε) with respect to an advantage in either the cost of financing (Case 1) or the cost of a credit guarantee (Case 2). Specifically, $1 + \varepsilon$ is the percentage gain in market share that would

result from a marginal percentage reduction in price; since a gain in market share is associated with a reduction in price, we associate with ε a negative sign. The second is the amount of investment (in whole loans or credit risk) by nonadopters is at stake in each risk segment; that is, how much could potentially shift to adopters? The first parameter allows us to quantify the potential impact for a segment of a given size within the mortgage portfolio of a nonadopters (step 1), while the latter allows us to aggregate among risk segments (step 2).

Step One: Size of transfer per risk segment. Consider first the case of a whole loan transfer (our case 1). The share of adopters after Basel II (S_a) in this case is defined as follows:

$$S_a = IS_a + (1 + \varepsilon)\, \Delta C/C_{na}\, IS_{na}$$

where IS_a is the initial share of this risk segment held by adopters; ΔC is the size of the cost advantage to adopters in this risk segment after Basel II; C_{na} is the cost of financing to nonadopters before Basel II is implemented (or under Basel I rules); and IS_{na} is the share of nonadopters before Basel II is implemented. In words, the new share for adopters is its initial share plus some fraction of the share held by nonadopters. The elasticity reflects the responsiveness of household demand for mortgage debt across various mortgage lenders to differences in the cost of debt.

We could find little direct evidence in the literature on this elasticity. However, anecdotes abound regarding the fragility of individual lenders' market shares and the highly competitive structure of the mortgage market, which leads us to posit an elasticity that is relatively large, in the range of -2 to -5.[29] Some affirmative insights were obtained

[29] The elasticity we have in mind has to do with household demand among many suppliers at one point in time, as distinct from the elasticity of the aggregate household demand for mortgage debt that was studied

from a recent study by Ambrose and Saunders (2003), who evaluate the probability that the originator of a mortgage will either hold or sell it. The estimated coefficients of their empirical model of the decision to hold or sell a loan can be used to infer the sensitivity of this choice to the lender's pricing advantage. We performed such calculations and concluded that the model suggests an elasticity of loan sale three or higher. Although this elasticity measure is not identical to the one we have in mind, the values calculated for it are consistent with a highly competitive market structure.

Simple examples to illustrate the impact of elasticity on the amount of investment that would shift from adopters to nonadopters within a particular risk segment are presented in Table IV-1. The calculated sizes of the transfer vary with assumptions regarding the initial market shares and the elasticities. The particular risk segment used in this example is the ARM with a market index of less than six months. Consistent with the calculations in Table III-I, the cost of financing to nonadopters is set at 310 basis points, and the cost advantage to adopters under Basel II at 14 basis points. In particular, we continue to assume that economic capital for credit risk is 100 basis points.

The largest impacts pertain to a case with a relatively small initial market share for adopters (30 percent) and a relatively high elasticity (-5). In this case, $332 million in annual net income associated with investing in this risk segment is transferred to adopters from nonadopters per $100 billion in this risk segment. Their market share increases from 30 to 42 percent of this risk segment, but they earn less per dollar of investment in this risk segment because they are assumed to price based upon their lower cost of

---

by Follain and Dunsky (1998) and Dunsky and Follain (2000). The only reasons it would not be "infinitely elastic" would be due to issues such as customer loyalty, the cost of searching among lenders, potential cross-selling benefits, etc. A quote from one lender with whom we spoke captures the spirit of what we have in mind: "the heightened focus of customers on the price of credit has reduced the value of customer loyalty to about 25 basis points."

capital. Nonadopters lose more than the adopters gain. Their market share declines to 58 percent and the price they earn on this smaller share also declines. The net impact is a loss $472 million per $100 billion in this risk segment. Lowering the elasticity to -2 and the adopters' initial market share to 45 percent reduces these estimates to $10 million gained by adopters and $150 million lost by nonadopters per $100 billion investment in this risk segment.

We apply similar logic to assess the potential size of the transfer that would occur in Case 2—credit risk transfer—for a particular risk segment, although the analysis for this case involves three distinguishing features. The first difference is the definition of the base price. Here we use the guarantee fee (G) charged for credit protection as the basis of the share calculation; that is,

$S_a = IS_a + (1 + \varepsilon)\, \Delta G/G_{na}\, IS_{na}$;

otherwise, all other terms are the same as in Case 1. The second difference is that we limit the maximum potential market share of adopters to 80 percent, which is what many believe to be the share of the GSEs in the market for credit risk protection for conforming mortgages.[30]

As with Case 1, we generate some examples to illustrate the potential impacts for particular risk segments.[31] One specific risk segment evaluated includes fixed-rate 30 year mortgages with the capital for interest rate risk set to 160 bps. As in Case 1, the largest impacts pertain to the case with a relatively small initial market share for adopters (30 percent) and a relatively high elasticity (-5). In this case, adopters earn an additional

[30] Implicitly, we are assuming in this example and throughout our analysis that the elasticity of market share approaches zero as the adopters' share approaches 80 percent; whatever dominance the adopters may gain will not exceed that currently enjoyed by the GSEs.
[31] Tables with our calculations are available upon request of the authors.

$126 million in annual net income associated with the provision of credit risk protection for this risk segment per $100 billion in this risk segment. Their market share increases from 30 to 80 percent of this risk segment; the 80 percent is the maximum we impose. Nonadopters lose $281 million per $100 billion in this risk segment. Lowering the elasticity and the initial market share assumptions produces a loss to both adopters and nonadopters. Adopters lose -$11 million per $100 billion of debt in this risk segment because the gain in market share is offset by a much lower price per dollar of credit protection offered.[32] Nonadopters lose $144 million per $100 billion investment in this risk segment.

Step 2: Aggregating among risk segments. The ideal set of information needed to classify residential mortgage debt held by banking organizations for our purposes -- the distribution of the debt across risk segments classified by degrees of interest rate and credit risk--is simply not available to regulators or to the public. Hence, we pursue a less ambitious approach and focus upon what we believe is the more critical variable – the distribution of mortgage debt across segments defined by amount of interest rate risk. Risk segments for this analysis are distinguished by the repricing dates or remaining maturities of closed, first lien mortgages on 1-4 mortgage loans. We use information on the distribution of mortgage holdings across such risk segments from first quarter 2004 Call Report data for commercial banks. We then average the aggregate impacts that are calculated for the various initial market share and elasticity assumptions used in Table IV-I. These results are summarized in Table IV-2.[33]

[32] The ex ante ROE remains 15 percent for the entire amount of the investment by nonadopters because we used this assumption in the calculation of the credit guarantee fee.
[33] A detailed explanation of the assumptions embedded in our estimates is available in the previous version of this paper and in a separate appendix available from the authors.

Consider, first, the aggregate gains to adopters under Case 1 and Case 2, which we estimate to be about $279 million and $116 million, respectively. We view these two estimates as offering a range of what may be gained by adopters not as separate components that should be added. Case 1 is more beneficial to adopters because they end of capturing the both the interest risk and credit risk income. If only Case 2 comes about, the number and amount of mortgage debt affected by Basel II would be the same as in Case 1. However, the amount of income transferred under Case 2 would be less because only the credit portion would be transferred. The more likely outcome is that some income will be transferred via Case 1 and some via Case 2.

The most important results from a policy perspective pertain to the potential losses to nonadopters. Recall that their losses stem from two forces: their shares of the market declines and the income earned per dollar of debt owned declines. Nonadopters are projected to lose $880 million per year under Case 1 and $655 under Case 2. These losses would not be uniformly distributed among all nonadopters. Mortgage specialists among nonadopters would be most impacted by the proposed rule, in part because the marginal amount of regulatory capital will likely be the leverage ratio and not even the Basel I capital rule.[34] The subset of these with relatively large amounts of ARMs would be among those likely to be most at risk from heightened competition from the adopters.

These results are sensitive to our assumptions. One particularly important one is the amount of first-lien, 1-4 family mortgage debt. We use the amount owned by commercial banks; including the roughly $500 billion of such debt owned by thrifts

---

[34] Using the definition offered by the FDIC – lenders with at least fifty percent of their assets in the form of residential mortgages and mortgage-backed securities –243 commercial banks (among 7,600) fit this description and these banks earn about $1.4 billion per year. We do not attempt to offer a precise estimate of their share of the losses, but it seems clear to us that the impact upon them would be substantial.

increases the impacts by 50 percent so that the estimated losses to nonadopters straddle $1 billion in lost income per year. As such, the calculations presented in Table IV-2 may be somewhat conservative. Moreover, these calculations do not consider the potential impact on high credit quality second mortgages.

V. Key Conclusions and Policy Suggestions

We argue that the proposed bifurcated implementation plan for Basel II in the U.S. is likely to have a significant impact on the competitive landscape within the banking industry in its competition for residential mortgage investments. The impetus is the sizeable decline in the Basel II capital requirements for residential mortgages that will be available to adopting banking organizations relative to the requirements (existing Basel I rules) that will continue to apply to nonadopting banking organizations. The decline for adopters will trigger a regulatory arbitrage process in which nonadopting banking organizations may experience a non-negligible reduction in net income due to a reduction in their share of the market and the reduced price they earn in such investments. Although nonadopters can seek to regain this income through other activities, the alternatives most readily available to them are likely to be relatively risky.

Although we readily acknowledge the difficulty of producing precise estimates of this impact with information available to the public and regulators, we believe the evidence is more supportive of this position than the view that there will be little or no effect. We also readily acknowledge that policy-makers may view the costs of such a distortion in the competitive landscape outweighed by other advantages to Basel II and the lower mortgage rates that will likely be available to borrowers.

Potential and partial remedies to the problems we envision are possible. In particular, the capital rules pertaining to residential mortgages for nonadopters can be adjusted downward for the credit risk embedded in them. Something like the risk-weights associated with the Standardized approach (35 percent versus the current 50 percent) would move a long way toward reducing the potential for competitive inequities. These reduced weights would be assigned to banking and savings organizations with geographically dispersed investment portfolio and interest rate risk management processes designed to keep such risk to levels acceptable to regulators.

As noted above, mortgage specialists would seem to be among those especially at risk of competition from adopters under the proposed implementation plan. Although some may be obvious candidates for a reduction in the risk-weight for residential mortgages, such a reduction may be of little benefit to some mortgage specialists with large concentrations of prime ARMs. This latter subset of mortgage specialists are likely be bound by the more stringent leverage requirements. Otherwise, these mortgage specialists become candidates for expansion into riskier asset categories or candidates for acquisition by more diversified institutions. A more radical approach suggested by some is to introduce an alternative and lower set of leverage requirements. For example, mortgage specialists with a high quality and geographically diversified portfolios would be subject to, say, a 3 percent Tier 1 leverage requirement in order to be considered adequately capitalized.[35]

We conclude with a brief discussion of another potential and related impact of the bifurcated approach. It stems from the omission in the Pillar I minimum capital

[35] See, for example, the comments of William Longbrake on behalf of Washington Mutual at: http://www.federalreserve.gov/SECRS/2003/November/20031106/R-1154/R-1154_67_1.pdf

requirements for mortgages under both Basel I and Basel II of a particularly critical component of the cost of investing in mortgages – capital for interest rate risk. This omission, in our view, has the potential to generate undesirable competitive responses by nonadopters to their competitive disadvantage with respect to capital for credit risk—that is, shifting their portfolio to higher risk assets, and especially, increasing their exposure to interest rate risk. As a result, regulators may want to commit to increase their monitoring of the interest rate risk of nonadopting organizations with substantial mortgage investments.

REFERENCES

Abrahams, Steven. "Planning for 2004: A Primer on Competitive Analysis." Bear Stearns & Co. Inc., *Agency CMOs Relative Value Outlook*, December 16, 2003: 4-8.

Allen, Linda, "The Basel Capital Accords and International Mortgage Markets: A Survey of the Literature," *Financial Markets, Institutions and Instruments*, vol. 12, no. 2 (2004, forthcoming).

Ambrose, Brent W., Michael LaCour-Little, and Anthony B. Sanders. 2003. "Does Regulatory Capital Arbitrage or Asymmetric Information Drive Securitization?" Paper presented to XII International Tor Vergata Conference on Banking and Finance, held at the University of Rome Tor Vergata, September 9-11, 2003.

Basel Committee on Bank Supervision. 2004. Basel II: International Convergence of Capital and Capital Standards: a Revised Framework, Basel Publication No. 107, June.

Blinder, Alan S., Mark J. Flannery, and James D. Kamihachi. "The Value of Housing-Related Government Sponsored Housing Enterprises: A Review of a Preliminary Draft Paper by Wayne Passmore." Fannie Mae Papers, Volume III, Issue 2, May 2004 and available at: http://www.fanniemae.com/commentary/pdf/fmpv3i2.pdf.

Board of Governors of the Federal Reserve System. "Mortgage Debt Outstanding." *Federal Reserve Bulletin*, December 2003, Table 1.54.

Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision. 2003 "Agencies Announce Publication of Documents Related to Basel Accord Implementation." Joint Press Release and Attachments (August 4). http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20030804/.

Bugie, S., T. Azarchs, Y. Burger, S. Quinn, "Basel II: No Turning Back for the Banking Industry," Standard & Poor's Research Report, August 22, 2003.

Cabral dos Santos, João, "Glass-Steagall and the Regulatory Dialectic," Economic Commentary, Federal Reserve Bank of Cleveland, February 15, 1996 and available at: http://www.clevelandfed.org/Research/com96/021596.htm

Calem, Paul S., and Michael LaCour-Little, "Risk-Based Capital Requirements for Mortgage Loans", *Journal of Banking and Finance* 28, pp. 647-672 (2004).

Calem, Paul S., and Rafael Rob, "The Impact of Capital-Based Regulation on Bank Risk-Taking," *Journal of Financial Intermediation* 8, pp. 317-352 (1999).

Calem, Paul S., and James R. Follain, "The Asset Correlation Parameter in Basel II for Mortgages on Single-Family Residences, Board of Governors of the Federal Reserve System (2003) (http://www.federalreserve.gov/generalinfo/basel2/docs2003/asset-correlation.pdf).

Dunsky, Robert, and James R. Follain, 2000. "Tax Induced Portfolio Reshuffling: The Case of the Mortgage Interest Deduction," *Real Estate Economics*, (with Robert Dunsky), Volume 28, 4:683:718.

Emmons, William R., Vahe Lskavyanand, and Timothy J. Yeager, 2005, "Basel II Will Trickle Down to Community Bankers, Consumers," *The Regional Economist*, St. Louis Federal Reserve Bank, April, 12-13.

Fannie Mae, 2004. A *Statistical Summary of Housing and Mortgage Finance Activities*. http://www.fanniemae.com/ir/pdf/resources/housingmortgage.pdf, Tables 3 and 5.

Federal Deposit Insurance Corporation. *An Update on Emerging Issues in Banking. Estimating the Capital Impact of Basel II in the United States.* Retrieved April 15, 2004, from Federal Deposit Insurance Corporation, FYI website: http://www.fdic.gov/bank/analytical/fyi/2003/120803fyi.html, 2003.

Ferguson, Roger W., Jr. "Basel II: Some Issues for Implementation," June 17, 2003; http://www.federalreserve.gov/boarddocs/speeches/2003/20030617/default.htm.

Follain, James R., and Robert Dunsky, 1997. "The Demand for Home Mortgage Debt and the Income Tax," (with Robert Dunsky), *Journal of Housing Research,* Volume 8, 2, 155-200.

Follain, James R. and Peter M. Zorn. "The Unbundling of Residential Mortgage Finance," *Journal of Housing Research,* 1(1), pp. 63-89 (1990).

Frame, W. Scott. "Federal Home Loan Bank mortgage purchases: Implications for mortgage markets." Federal Reserve Bank of Atlanta *Economic Review* vol. 88 (3), pp. 17-31 (2003).

Frame, Scott W. and Lawrence J. White. "Emerging Competition and Risk-Taking Incentives at Fannie Mae and Freddie Mac." New York University, Leonard N. Stern School of Business working paper EC-04-02, 2004.

Freddie Mac's Aggressive Pricing Strategy. Inside Mortgage Finance Publications, *Inside MBS & ABS.* November 21, 2003, Issue 2003:44.

Freddie Mac's Business Developments. Retrieved April 15, 2004, from Freddie Mac, Investor Resources, Investor Presentation website: http://www.freddiemac.com/investors/ (Slide 37).

Freddie Mac's Report on 2003 Financial Results. Retrieved at: http://freddiemac.com/investors/er/pdf/2003fin-tbls_063004.pdf, Table 6, June 30, 2004.

Glenn, David W. "Future Trends in Mortgage Finance," *Mortgage Banking*, April 1999: http://www.housingfinance.org/IndustryInformation/NAmerica_GlennArticleJune99HFI.pdf

Hancock, Diana, Andreas Lehnert, Wayne Passmore, and Shane M. Sherlund, 2005, "An Analysis of the Potential Competitive Impacts of Basel II Capital Standards on U.S. Mortgage Rates and Mortgage Securitization." Federal Reserve Board, April.

Jones, David S., "Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues," *Journal of Banking and Finance* 24 (2000), pp. 35-38.

Kane, Edward J., "Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Banking Regulation," *Journal of Finance*, vol. 36, no. 2 (May 1981), pp. 355-67.

Kovakimian, Armen, and Kane, Edward J., "Effectiveness of Capital Regulation at U.S. Commercial Banks, 1985 to 1994 ," *Journal of Finance*, Vol. LV, No. 1 (February 2000), pp. 451-468.

Myers, Stuart C., and James A. Read, Jr. "Capital Allocation for Insurance Companies," *Journal of Risk and Insurance*, Vol. 68, 4, December, 545-580. 2001.

Nakada, Peter and Andrew Hickman. 2003. "Comments on the Advance Notice of Proposed Rulemaking for *Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord*," October 17, 2003.

Kramer, Bruce. "Non-Agency MBS: Opportunities in a Post-Refi Environment," in *Proceedings of a Conference on Mortgage and Structured Products* (Bear Stearns, January 15, 2004).

Office of Federal Housing Enterprise Oversight. *2003 Report to Congress.* Washington; Office of Federal Housing Enterprise Oversight.

Office of Thrift Supervision. *Selected Asset and Liability Price Tables as of December 31, 2003.* Washington: Office of Thrift Supervision, 2004.

Office of Federal Housing Enterprise Oversight. 2003. *Risk-Based Capital Regulation.* Washington: Office of Federal Housing Enterprise Oversight, 2003.

Office of Federal Housing Enterprise Oversight, 2004. Mortgage Markets and the Enterprises, 2003. Washington: http://www.ofheo.gov/media/pdf/MME2003.pdf

Passmore, Wayne. "The GSE Implicit Subsidy and Value of Government Ambiguity." Federal Reserve Board working paper, 2003-64 (December).

Posner, Kenneth A. (and Mita Nambier). "The American Dream Industry, 2002-2020." Morgan Stanley Equity Research, U.S. Mortgage Finance, February 5, 2002.

Pafenberg, Forrest. *The Single-Family Mortgage Industry in the Internet Era: Technology Developments and Market Structure*. OFHEO Research Paper. Washington: Office of Federal Housing Enterprise Oversight, 2004.

Rochet, J.C. "Capital Requirements and the Behavior of Commercial Banks," *European Economic Review* 36, pp. 1137-1178 (1992).

Sandler, Herb 2003. "Supplemental Comment on Basel II's Advanced Notice of Proposed Rulemaking," November. See: http://www.federalreserve.gov/SECRS/2003/November/20031113/R-1154/R-1154_80_1.pdf.

Standard and Poor's. "Basel II: No Turning Back for the Banking Industry." August 22, 2003.

White, Geoffrey. 2003. "Possible Effects on Competition in the U.S. Banking Industry of Two-Tiered Implementation of the New Basel Capital Accord." Office of the Comptroller of the Currency.

Van Order, Robert. 2000. "The U.S. Mortgage Market: A Model of Dueling Charters." *Journal of Housing Research,* 11(2), pp. 233-4 (2000).

Van Order, Robert. "A Microeconomic Analysis of Fannie Mae and Freddie Mac." *Regulation*. 23(2), 27-33 (2003).

Table II-1: Proposed Basel II Capital for 1-4 Family Residential Mortgages

Selected examples of simulated PD, LGD, and Basel II capital by risk segments
(Default defined as first occurrence of 180-day delinquency)

LTV / FICO Score	Annualized 10-year Default Rate (PD) (percent) (1)	Loss Generated by Default (Recession LGD) (percent) (2)	Risk Weight (percent) (3)	Marginal Tier 1 Capital Requirement (Basis points) (4)
70 / 620	0.27	16	9	34
70 / 660	0.16	16	6	23
70 / 700	0.10	16	4	16
70 / 740	0.07	16	3	12
80 / 620	0.51	20	17	67
80 / 660	0.31	20	12	48
80 / 700	0.20	20	9	35
80 / 740	0.15	21	7	29
90 / 620	1.00	25	34	136
90 / 660	0.62	26	25	100
90 / 700	0.42	26	19	76
90 / 740	0.30	26	15	61
95 / 620	1.38	26	45	181
95 / 660	0.87	27	34	135
95 / 700	0.58	28	26	104
95 / 740	0.43	28	21	84
Jumbo Prime Pool	0.27	25	13	53
Alt-A Pool	0.28	35	19	77
Seasoned & Diversified Portfolio of Prime Loans	0.19	25	10	40

Source: Calem and Follain (2003).

Table III-1: Examples to Demonstrate the Cost Advantage to Adopters

	Duration of Asset	Duration of Liabilities	Capital for IRR for Typical Financing Kirr	Capital for Credit Risk (bps) Kcr	Total Econ K to Adopter	Total Capital for NonAdopter	Capital Advantage to Adopter	Cost of Financing to Adopter (bps)	Cost of Financing Advantage of Adopter (bps)
30 FRM Loans	3.5	1	500	100	600	600	0	330	0
30 FRM Loans	3.5	2	300	100	400	400	0	310	0
30 FRM Loans	3.5	NA	160	100	260	400	140	296	14
Market Index< 6 months	0.29		160	100	260	400	140	296	14

Table III-2: Examples of the Advantage to Adopters in Case 2 (Credit Risk Transfer)

	Effective Duration	Duration of Liabilities	Econ K for additional CR for Adopters	Reduced K due to CR Layoff for Nonadopters	Capital Advantage to Adopter	Cost of Credit Guarantee to Adopter (bps)	Cost of Credit Guarantee to NonAdopter	Cost of Credit Guarantee Advantage of Adopter (bps)	Cost of Credit Guarantee Advantage to Adopter (percent)
30 FRM Loans	5.6	1	100	100	0	35	33	-2.00	-6.2%
30 FRM Loans	3.5	2	100	100	0	35	33	-2.00	-6.2%
30 FRM Loans	3.5	NA	100	240	140	35	50	15.50	31.0%
Market Index< 6 months	0.29		100	240	140	35	50	15.50	31.0%

Table IV-1: Calculating size of income transfer via Case 1 for ARM with index adjustment less than six months

	Initial Share for Adopters	Cost of Financing Advantage to Adopters (bps)	Original Cost of Financing to Nonadopters (bps)	dCF/CF	Elasticity ε	New Share for Adopters (1+ ε)dc/c + S)	Additional Income for Adopters (bps)	Income Loss to Nonadopters (bps)	Net Income Gains to Adopters per $100 billion of UPB	Net Income Loss to Nonadopters per $100 billion of UPB
	30%	14	310	-4.5%	-5	42.6%	33	(47)	$ 332,296,774	$ (472,296,774)
	30%	14	310	-4.5%	-4	39.5%	24	(38)	$ 238,722,581	$ (378,722,581)
	30%	14	310	-4.5%	-3	36.3%	15	(29)	$ 145,148,387	$ (285,148,387)
	30%	14	310	-4.5%	-2	33.2%	5	(19)	$ 51,574,194	$ (191,574,194)
	45%	14	310	-4.5%	-5	54.9%	23	(37)	$ 231,090,323	$ (371,090,323)
	45%	14	310	-4.5%	-4	52.5%	16	(30)	$ 157,567,742	$ (297,567,742)
	45%	14	310	-4.5%	-3	50.0%	8	(22)	$ 84,045,161	$ (224,045,161)
	45%	14	310	-4.5%	-2	47.5%	1	(15)	$ 10,522,581	$ (150,522,581)
Average	37.5%	14	310	-4.5%	(3.50)	44.6%	15.6	(29.6)	**$ 156,370,968**	**$ (296,370,968)**

Table IV-2: Aggregate Impacts of Case 1 and Case 2

Time to Repricing	Amount Held by Adopters	Shift to Adopters in Case 1	Shift to Adopters in Case 2	Loss to Nonadopters in Case 1	Loss to Nonadopters in Case 2
Lt 3 months	13%	$ 81,672,171	$ 34,116,638	$ (257,989,710)	$ (191,787,927)
3-12 months	7%	$ 42,609,884	$ 17,799,282	$ (134,598,007)	$ (100,059,312)
1- 3 years	11%	$ 68,958,873	$ 28,805,956	$ (217,830,375)	$ (161,933,730)
3- 5 years	16%	$ 20,272,519	$ 8,468,371	$ (64,037,741)	$ (47,605,254)
5-15 years	24%	$ 29,418,656	$ 12,288,955	$ (92,928,966)	$ (69,082,809)
GT 15 years	29%	$ 35,910,481	$ 15,000,763	$ (113,435,633)	$ (84,327,336)
Total	100%	**$ 278,842,583**	**$ 116,479,964**	**$ (880,820,434)**	**$ (654,796,368)**

STATEMENT OF

THOMAS J. CURRY
DIRECTOR
FEDERAL DEPOSIT INSURANCE CORPORATION

on

BASEL II: CAPITAL CHANGES IN THE U.S. BANKING SYSTEM AND THE RESULTS OF THE IMPACT STUDY

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

and

SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE, AND TECHNOLOGY

of the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

May 11, 2005
Room 2128, Rayburn House Office Building

Chairman Bachus, Chairman Pryce, Ranking Member Sanders, Ranking Member Maloney and members of the subcommittees, it is a pleasure to appear before you today to discuss the perspectives of the Federal Deposit Insurance Corporation regarding Basel II. Basel II is an effort to tie capital requirements more closely to risk and promote a disciplined approach to risk management at our largest banks. The FDIC supports these goals and the process of implementing a revised capital framework in the United States.

My testimony will focus on some concerns the FDIC has about the results of the recent quantitative impact study, QIS-4. I will also have some comments about the requirements for operational risk capital. The issues we discuss today may sound sweeping and fundamental, but we believe they can be resolved. Our intention is to work with our fellow regulators to address our concerns and to move forward expeditiously when this is done.

Background

In June 2004, the Basel Committee achieved an important milestone with the publication of "International Convergence of Capital Measurement and Capital Standards," representing an informal agreement among the Committee members about the framework that would form the basis of national supervisors' efforts to implement the new approaches. When publishing the new framework, the Basel Committee recognized that individual countries must decide how to implement the new capital measurements and standards, given their own unique circumstances. The four federal banking agencies

are in the process of drafting a proposed rule to implement Basel II's "Advanced Approaches" in the United States. The term "Advanced Approaches" refers to the Basel II approaches that rely most fully on banks' own risk estimates.

The FDIC brings a number of perspectives to the proposed rulemaking process. In addition to our role as primary federal supervisor of a number of institutions that have indicated an interest in opting in to the new framework, the FDIC's role as deposit insurer requires a keen interest in the risk profile of any bank adopting the new framework. In both our supervision and deposit insurance roles, we interact with the thousands of banks where capital will not be set by the Basel II standards, but will be affected, directly or indirectly, by the adoption of Basel II.

The work on the proposed rule, like all the agencies' work on Basel II, has been intensely collaborative, and characterized by vigorous give-and-take on many individual issues. In such a process, there is always a danger that the focus on the details can result in a loss of focus on the big picture. It is important from time to time to step back and take a fresh look at the totality of what we have created through years of negotiations. There have been a number of such opportunities during the development of Basel II. The 2004 Basel text was preceded by the Basel Committee's publication of three consultative papers, each of which received extensive comment from the banks that would be most affected. There were also various quantitative studies in which participating banks provided their own risk inputs to simulate the potential capital impact of the proposals.

The comments received on each of the consultative papers and the insights gained from the quantitative studies resulted in significant changes to the framework over the years.

In the light of all the changes to the new framework, culminating in the Basel Committee's 2004 mid-year text, the U.S. agencies embarked on a fourth quantitative impact study, QIS-4. QIS-4 is a comprehensive effort completed by 26 large U.S. consolidated banking organizations during late 2004 and early 2005. The purpose of the impact study was to use these organizations' internal estimates of the key risk parameters driving capital requirements for credit risk and operational risk under the Basel II framework (not all banks provided estimates of exposure to operational risk). Each bank's risk parameters and exposures were fed into the Basel II formulas to estimate the minimum capital requirements that would result for each consolidated banking organization and each line of business under the new framework. The agencies have long envisioned that QIS-4 would serve as an important input to the proposed rulemaking process.

A summary of the results of QIS-4 is contained in an appendix to this testimony. It is important to note that these results are preliminary and that the agencies' review of QIS-4 is not complete. Nevertheless, in part because the QIS-4 results are consistent with previous FDIC analysis, we have formed some preliminary conclusions.

In the FDIC's view, QIS-4 shows excessive reductions in risk-based capital requirements. Capital requirements fell by more than 26 percent in more than half of the

institutions in the study. This is without fully factoring in the benefits of credit risk hedging and guarantees that are likely to reduce capital requirements significantly more. For individual loan types at individual banks, over one third of the reductions in capital requirements were in the range of 50 to almost 100 percent. Numbers like this do not provide comfort that the Basel framework will require capital adequate for the risks of individual activities.

The FDIC also is concerned that the dispersion of results suggests there is a difficulty in applying the framework consistently across banks. Capital requirements in Basel II are very sensitive to inputs. Achieving consistency in Basel II depends on the idea that best practices, and best data, will lead to convergence in the capital treatment of similar loan portfolios across banks. At present, however, at least as indicated by QIS-4, there is little commonality in the approaches the various banks used to estimate their risk inputs.

The FDIC has communicated on many occasions about the continued need for a leverage ratio. As discussed at greater length later in this testimony, the QIS-4 results suggest that U.S. leverage requirements will be more important under Basel II than ever before. The FDIC can support moving forward with this new framework only because of the existence of the leverage-based component of U.S. capital regulation.

The FDIC also has a concern about the potential competitive effects of the new framework. If QIS-4 is representative of capital requirements going forward under Basel

II, the competitive ramifications for community banks and large non-adopting banks could, in our view, be profound. If Basel II is implemented unchanged, mitigating these competitive effects would seem to require a substantial reduction in risk-based capital requirements for non-Basel banks.

The remainder of this testimony will contain a brief summary of how Basel II computes capital requirements and the conceptual change this approach represents. This is followed by a discussion of the QIS-4 results—our concern with those results—the role of the leverage ratio in U.S. capital regulation, competitive equity issues, and some observations on key implementation issues.

A new paradigm for capital regulation

To provide perspective, it is worthwhile to reflect on the overall thrust of the change that Basel II represents. The fundamental changes represented by Basel II provide an incentive to improve risk management practices, and elevate the role of banks' and supervisors' judgment in determining risk-based capital requirements. While this judgment is expected to be informed by analysis, the importance of judgment is nevertheless infinitely multiplied under Basel II's advanced approaches.

To calculate capital requirements for credit risk under the current capital standards (Basel I), each exposure is slotted into one of a few simple categories, each with a predetermined capital requirement. Under Basel II, the same exposure could

attract a capital charge of anywhere from essentially zero to many multiples of the current charge, depending on specific risk inputs for that exposure estimated by the bank and approved by the supervisor. The capital requirements under the proposed Basel II will be much more risk-sensitive, and much more subjective, than at present.

Basel II computes minimum capital requirements for credit risk using a set of formulas that are, at least in comparison to other risk-modeling approaches, relatively simple. The inputs to these formulas are probability of default (PD), loss given default (LGD), exposure at default (EAD) and, for wholesale exposures, maturity (M). While each bank supplies its own inputs, the regulators have developed the formulas themselves through the Basel Committee on Banking Supervision. The regulators have six separate formulas for: wholesale credit exposures, small business wholesale exposures, high volatility commercial real estate, revolving exposures (mostly credit cards), residential mortgages, and other retail loans. The capital requirement is computed for each exposure or pool of exposures based on the inputs the bank provides and added across the entire bank to get the total capital requirement for credit risk. The capital requirement is always eight percent of risk-weighted assets, just as it is now, but the risk weighted asset number now becomes the byproduct of the aforementioned calculations and assumptions.

One of the outputs of the calculations above is a number called the "expected loss," interpreted as the amount of credit losses a bank would expect over a one year period given the assumptions it made about the PDs and LGDs for its exposures. The total expected loss for the bank is compared to its allowance for loan and lease losses and

other reserves. If the expected loss exceeds these reserves, the difference is deducted from capital. If reserves exceed expected loss, the excess up to a limit is added to capital. These adjustments can add quite significantly to the capital requirements for certain kinds of retail credit, especially credit cards.

A capital requirement also exists for operational risk. Operational risk is the risk of loss associated with human error, failed systems or external events. As discussed later in this testimony, banks will develop historical databases of operational risk losses under the "Advanced Measurement Approach" (AMA). Banks will use these databases to attempt to estimate an amount of operational loss that is highly unlikely to be exceeded. At least in theory, a bank will estimate an amount of capital sufficient to absorb operational loss in 99.9 percent of all scenarios. This estimated loss, after subtraction of certain offsets such as permissible reserves, is—with supervisory approval—the bank's operational risk capital requirement. Banks outside the U.S. are permitted to use simpler approaches to calculate capital for operational risk.

Although this describes the relatively simple part of the Basel II framework, there also is an extremely detailed, complex, formula-driven and internal model-driven infrastructure surrounding the calculation of capital for exposures to securitization, repurchase agreements, equity investments, and a host of other exposure issues that are beyond the scope of this testimony.

The QIS-4 results

Data for the QIS-4 was collected in late 2004 and early 2005 and have been under review since February of this year. The preliminary review suggests that if the QIS-4 is representative of the risk inputs banking organizations use to calculate their capital requirements going forward, risk-based capital requirements in aggregate would decline by roughly 17 percent. An aggregate capital number is of some interest, but perhaps less important in terms of competitive implications and risks to the insurance funds than the results for individual banks. Half of the 26 banking companies participating in the QIS-4 reported capital reductions in excess of 26 percent, with a number of institutions reporting reductions in overall capital requirements in the range of 30 to 50 percent. Other banking companies reported increases in capital requirements of as much as 60 percent.

Capital requirements for specific business lines also showed striking results. Preliminary estimates show capital requirements for wholesale loans down 24 percent in aggregate, with the outcomes ranging from an increase of more than 50 percent to a decrease of almost 75 percent. Capital for high volatility commercial real estate was down 33 percent in aggregate. The wholesale lending category, in particular, is an area where banks appear to have substantial latitude to take advantage of the benefits of guarantees and credit risk hedging in order to further reduce their capital requirements.

Preliminary results show that capital requirements for retail loans were down 26 percent in aggregate, with half the banks showing a reduction of 50 percent or more. Within that retail category, capital requirements for mortgage loans showed a decline of 62 percent in aggregate, with half the banks showing declines in excess of 73 percent. Capital requirements for home equity lines of credit were down 74 percent, with half the banks showing declines in excess of 79 percent. Capital requirements for credit cards were up substantially on average, but ranged from over a 100 percent increase to a decrease of 90 percent.

A number of observations about these results are in order. First, at this time the framework does not appear to comport with the stated expectation of the Basel Committee that overall capital should remain about the same throughout the system, with perhaps only modest reductions. While some have accused the framework of excessive conservatism, the QIS-4 results suggest that Basel II in its current form would bring substantial reductions in risk-based capital requirements. In terms of their average direction and magnitude, the FDIC does not see these QIS-4 results as surprising. An FDIC paper published in December 2003 suggested that when reasonable PDs and LGDs, estimated based on twenty years of U.S. bank charge-off history, are entered into the underlying Basel II credit risk formulas, those formulas can be expected to deliver substantial reductions in risk-based capital requirements.

The QIS-4 results also illustrate that under the advanced approaches, there is potential for substantial dispersion in capital requirements in ways that are not

explainable by real differences in risk. Capital requirements under the advanced approaches depend heavily on the answers to questions that have no objectively best answer. For example, if a borrower defaults in the future, how much will the bank lose per dollar of the loan? One expert might guess 20 cents on the dollar and another might guess 30 cents on the dollar. While reasonable people might be hard-pressed to decide which expert is correct, the conclusion reached in this specific example would swing the Basel II capital requirement by 33 to 50 percent.

The agencies did, in fact, observe a wide range of practice in how banking organizations estimated their PDs, LGDs and exposures for QIS-4 purposes. This range of practice suggests that considerable practical challenges lie ahead in the supervision of Basel II's advanced approaches. In part, the challenge will be to achieve consistent application of Basel II across institutions. We may want to avoid a situation where a banking organization's Basel II risk-based capital requirement is, for all practical purposes, whatever capital level is acceptable to its regulator. To limit the potential unintended consequences of such a situation, implementing Basel II implies the need for an unprecedented degree of market transparency, interagency collaboration and information sharing. From the FDIC's perspective of assessing risks to the insurance funds, collaboration should include access by all bank regulators to information about the critical assumptions, models and data used to implement capital requirements based on banks' own estimates of risk.

Another important issue relates to the capital treatment of new or emerging lines of business where there is little or no relevant history of loss experience. The recent rapid growth of home equity lines of credit provides a useful current example. FDIC-insured institutions' holdings of this product have tripled in the past 5 years. This rapid growth, the unseasoned nature of the portfolio, and the agencies' belief that home equity lenders' underwriting standards have loosened considerably in recent years all suggest that a certain amount of supervisory and regulatory caution is appropriate. The recent loss experience, however, is favorable, and this is what drives the 80 percent capital reduction for this activity reported in the QIS-4.

As long as banks are growing and innovating, there will always be new and rapidly growing lines of business with little relevant loss history. The example of home equity lending suggests to us that Basel II has not solved the problem of finding the "right" level of capital for such emerging activities, and that further thought is needed about the appropriate prudential approaches in this area. For example, to what extent will the significant reductions in capital requirements for these activities result in a de facto expansion of the federal safety net? One of the classic antidotes to the moral hazard problems associated with deposit insurance is for regulators to require an adequate amount of private equity capital to be at risk. In this respect, the QIS-4 results for mortgages and home equity loans suggest the need for a hard look at how this part of the Basel II framework should be implemented.

The Basel Committee envisioned that calibration issues could be handled by means of a simple multiplier. Specifically, if at some future date the Committee decides that the overall capital required under the new framework is inconsistent with its objectives, either because of being too high or too low, the Committee has reserved the option of proposing that each jurisdiction multiply the capital requirements by a single number, thereby bringing overall capital more in line with the Committee's objectives. Given the wide dispersion and extreme outcomes of the QIS-4, it appears at this time that the need for adjustments to the framework for U.S. implementation purposes could go beyond a simple multiplier adjustment. Serious thought needs to be given to finding ways to achieve results under Basel II that are less extreme and more consistently applicable across banks.

The accuracy of Basel II and the role of the leverage ratio

The Basel II capital accord reflects the significant input of the world's largest banks and has been described by some as a codification of current best practices in risk measurement with a dose of conservatism. Given all this, a natural question that many U.S. bankers have asked is why the U.S. regulators would not place exclusive reliance on the results of the Basel II formulas. These bankers have asked why the U.S. leverage ratio requirements would not be jettisoned or phased out over time as part of the implementation of Basel II. Indeed, they ask, if leverage ratio requirements are retained, why bother with Basel II?

Clearly, a robust and appropriate set of risk-based capital requirements is an important part of our overall regulatory capital system. An equally important role is played by the leverage ratio to ensure that regardless of the risk-based capital model used by a Basel II bank, there will be a base level of capital available in the event of a crisis. Basel II, with its reliance on internal methods and models, does not provide us with that same degree of comfort because there can be little certainty that the Basel II formulas produce an adequate level of capital. For many reasons, we believe that the leverage ratio will continue to serve as a relevant and reliable indicator of bank solvency to be used in conjunction with the Basel II risk-based measures.

First, the Basel II minimum capital measure is not comprehensive. For example, capital is not required for interest rate risk associated with loans held to maturity, or for liquidity risk. These are material risks. The elimination of the leverage ratio would send the signal that these are secondary risks of little importance to the regulatory community.

Second, Basel II is only as good as the inputs entered into the formulas. Analytical mishaps or faulty assumptions that prove to be overly optimistic could have a disastrous effect on the solvency of an institution, as well as the financial system.

Third, no matter how the data used to drive the capital calculation is sliced, we cannot lose sight of the fact that the past ten years have been some of the best years in banking. It is difficult to expect this data—collected during good economic times—will be sufficient to generate capital requirements robust enough to withstand extreme losses

under adverse conditions. While the past can be a useful guide to the future, reliance on historical losses as the risk profile of the business line increases could leave a bank unprepared to absorb unexpected losses.

It should also be noted that the Basel II formulas include assumptions with recognized limitations. In Basel II, LGDs are assumed not to increase during a recession. This amounts to assuming that extreme loss scenarios will be less extreme than they might actually be. In Basel II, capital requirements are literally zero for an exposure with a zero reported LGD, whereas economic theory suggests if the bank is being compensated for holding the exposure, this compensation is in return for assuming some risk. In Basel II, credit losses are assumed to have a normal distribution, whereas there is widespread consensus that historical credit losses display a much greater frequency of extreme outcomes than would be predicted by a normal distribution.

While all of these factors bias the capital requirement downward and work against its ability to serve as a buffer against unexpected losses, Basel II does contain other elements that work against these downward biases. The most important is probably that the total capital required for all exposures is the sum of the capital for the individual exposures. This approach, by design, does not allow the bank to benefit from the fact that not all its portfolios are likely to experience the thousand year flood at the same time. Another important factor driving Basel II is the extent that defaults are assumed likely to occur together. The greater this correlation among defaults, the higher the Basel capital

requirement. There appears to be a consensus that Basel II is relatively conservative in its correlation assumptions.

The net effect of these multiple offsetting assumptions is that we cannot have confidence that the capital requirement coming out of a Basel II formula is "the right number," even if reasonable PDs and LGDs were used as inputs. Nevertheless, the hope is that the capital requirements coming out of Basel II will encourage over time a disciplined approach to risk measurement, provide a relative measure of risk among asset types and lessen the incentives for banks to structure their activities in ways that are driven primarily by flaws in regulatory capital.

Quite apart from the specifics of the Basel II models, there is a more fundamental issue that some have raised about the future role of the leverage ratio within the overall structure of U.S. bank capital regulation. The leverage ratio is a simple, clear-cut minimum amount of capital banks need to hold as a percentage of their assets. As indicated earlier, some observers are now suggesting that the arrival of Basel II will, sooner or later, make the leverage requirement obsolete. A closely related idea is that the appropriate benchmarks for capital regulation are banks' own estimates of their capital needs. According to this view, regulators should always set capital requirements less than what "best practice banks" estimate is optimal for their own needs. Requiring more capital than this, it is said, distorts the otherwise optimal function of the marketplace.

This conflicts with a large body of longstanding academic literature, and with the principles reflecting that view as embodied in the FDIC Improvement Act. The existence of a substantial federal safety net underlying banking, including but not limited to deposit insurance, means that the marketplace left to its own devices is likely to establish capital levels for banking organizations that are too low. This reflects the so-called "moral hazard problem" associated with safety nets. Because some creditors, and most notably insured depositors, are insulated from risk, those creditors do not demand any compensation for an increase in the bank's risk profile. The bank, consequently, takes on more risk than it otherwise would. As a result, the argument suggests that a bank enjoying a measure of federal safety net support will tend to hold less capital to support a given risk profile than if it did not enjoy the safety net support.

This is a standard rationale for bank capital regulation and the fundamental basis for the FDIC Improvement Act's Prompt Corrective Action requirements to maintain bank capital at prudent levels. Indeed, if the market could be relied upon to maintain acceptable levels of bank capital, there would seem to be no need for regulatory capital standards. In that case, bank supervision should be sufficient to address any outlier institutions with below-market capital positions.

To suggest that a bank's estimate of its own capital needs is an optimal number ignores both the moral hazard problem and the systemic implications of a large bank failure. There are, in short, legitimate and compelling public policy reasons for bank regulators to require more capital than what a bank estimates for its own needs.

Despite the intensive effort on Basel II development, the framework continues to produce outcomes with which supervisors are not comfortable. The QIS-4 results support the notion that no matter how refined the risk-based capital framework, there will always be a need for straightforward capital minimums. Phasing out the leverage ratio would suggest a willingness to contemplate a significant expansion of the federal safety net, and a significant increase in risk to the financial system. As stated earlier, the FDIC is able to support moving forward with Basel II primarily because of the continued existence of a set of straightforward leverage requirements.

Competitive effects

Absent a substantial reduction in capital requirements for non-Basel II banks, implementing risk-based capital requirements along the lines depicted in the QIS-4 results could have profound competitive implications and could significantly harm the community banking sector in the U.S., as well as large non-adopters. In our market economy, assets and lending will migrate to where it is most economical to house them. Today, risk-based capital requirements for identical assets are identical across banks so that there is no systematic regulatory capital economy achieved by moving an asset from a small bank to a large bank. Basel II would appear to create significant differences between the capital requirements of small and large banks for many activities. Owners of small banks will receive sub-par returns on their investments in capital-disadvantaged assets compared to the returns that owners of large banks could earn on the same assets.

As a result, market forces would likely drive those assets over time away from smaller banks, toward the Basel II adopting banks.

Certainly many factors other than regulatory capital have influenced the distribution of lending activity between small and large banks over time. In fact, since identical assets have received identical capital requirements across banks, one could argue that regulatory capital played no role in affecting market shares. If Basel II results in significant differences in the risk-based capital requirements of small and large banks, it is likely to alter the existing equilibrium.

The FDIC believes it is important to address the potential competitive implications of Basel II. In part, this could be achieved by revisions to the general capital requirements for all U.S. banks. From the standpoint of competitive equity, such revisions ideally would produce like capital requirements for like assets, regardless of whether the bank holding the asset is a Basel II bank or a non-Basel II bank. The magnitude of capital reductions suggested by the QIS-4, however, is likely to raise other issues. As yet, neither bank supervisors nor the FDIC in its role as insurer have had serious discussions about reducing risk-based capital requirements for all U.S. banks in a way that would broadly match the reductions suggested by QIS-4. It is likely, however, that such a discussion would raise issues not only about competitive equity, but about the safety and soundness implications of such a substantial reduction in capital requirements. Moreover, should large financial institutions employ their excess capital through acquisitions of non-Basel II institutions, then this framework would result in a shift in the

industry toward greater consolidation, and concentration of exposure and risks. Finding ways to moderate Basel II's potential for extreme results might make these competitive equity considerations easier to address.

Potential revisions to capital standards for non-Basel banks

The U.S. agencies are preparing a proposal outlining potential changes to risk-based capital regulations for all U.S. banks. The agencies will be soliciting comments on ways to achieve greater risk sensitivity in capital in a way that does not create undue burden for insured institutions and is consistent with safety-and-soundness objectives.

These proposals will likely focus on a number of ideas, such as the creation of additional risk buckets for various lending categories, expanded recognition of collateral, and enhancements to the current rules in a few specialty areas. Expanded risk buckets would allow for lower capital requirements for less risky assets and higher requirements for more risky assets. It is anticipated that comments by banks and thrifts will contribute significantly to the agencies' discussions of the factors that should be considered in assigning assets to specific risk buckets. Moreover, unlike Basel II which has separate charges for credit risk and operational risk, the agencies do not envision a capital charge for operational risk to be applied to non-Basel II banks in the U.S.

Current plans are to publish the new capital proposals for all U.S. banks simultaneously with the Basel II proposed rule. These proposals could be compared

side-by-side to determine the likely competitive implications of the overall package of proposed changes to U.S. capital regulation.

Implementation issues for insured depository institutions

Global banking organizations have expressed a concern about the practicality of implementing Basel II if the supervisors of individual banks around the world all insist on a bank by bank implementation of the new framework. In the extreme scenario, every bank could be required to maintain its own historical loss databases for credit and operational risk, a separate credit rating system, separate methodologies for determining PDs and LGDs, separate internal audit of the results, and so on. Such a situation would represent an inefficient allocation of resources and, from the perspective of an organization with many subsidiaries, would be unworkable.

At the same time, we must consider the perspective of supervisors of individual banks or other entities such as broker dealers. The supervisors, and for that matter boards of directors and senior management, have significant legal and statutory mandates to ensure the safe and sound operation of the entities under their jurisdiction and governance. In a Basel II world, these supervisors are going to need capital requirements that make sense for their individual supervised entities. Clearly, there is a tension between the responsibilities of individual supervisors and the cost advantages of organization-wide approaches to the implementation of Basel II.

In managing this tension, the principle of absolute accountability of the management and directors of FDIC-insured institutions for the governance of their institutions needs to be preserved. The FDIC's considerable potential deposit insurance liability and, conversely, its ability to recover over time the costs of that liability are specifically attached to insured institutions. It is certainly true that there are large financial conglomerates that in the normal course of events manage on a business line basis rather than a legal entity basis. History has demonstrated repeatedly, however, that in severe, solvency-threatening conditions, organizations move to defend themselves along legal boundaries. The legal location of risks and capital matter very much in these scenarios. That is why the only relevant measures of risk and of regulatory capital adequacy for an insured bank are measures of the bank's risk and the bank's capital. While there may be synergies in data and models that can be realized to streamline the implementation of Basel II in a conglomerate, such models and the data must capture the unique risks present in insured banks that may not be captured if such analysis was performed on a consolidated basis.

The practical questions surrounding these issues are currently being debated vigorously with respect to the proposed capital requirements for operational risk. The Basel II text contains a provision that, with supervisory approval, non-significant subsidiaries of organizations adopting the advanced approaches need not adopt their own advanced measurement approach (AMA) for operational risk. Instead, these non-significant subsidiaries could rely on an "allocation" of the AMA computed by the larger organization. Moreover, again with supervisory approval, that allocation could reflect

"diversification benefits." Diversification benefits in this context essentially refers to the idea that not every legal entity within an organization is likely to have high operational losses at the same time. Consequently, each entity's capital requirement should be lowered relative to the stand-alone amount it would have to hold if it computed its own AMA, reflecting, in effect, an averaging out of potential losses across multiple entities. The use of capital allocation to determine a non-significant subsidiary bank's operational risk capital requirement, and the possible use of diversification benefits to reduce those capital requirements, are collectively known as the hybrid approach to the AMA. Under a hybrid approach, significant banks would compute a stand-alone AMA while non-significant banks need not do so.

The concept of "capital allocation" depends on the idea that the relevant measure of operational risk is at the holding company level and not at the bank level. The idea of diversification benefits goes farther and assumes, in effect, that capital in any legal entity within a holding company structure is equally available to each of the legal entities. Both of these ideas are inconsistent with the fundamental principle that the relevant measures of risk and regulatory capital for an insured bank are those measures that refer to that bank's risk and that bank's capital. Compromising this principle would tend to erode the accountability of the insured bank, contribute to a de facto extension of the federal safety net to non-bank entities, and increase risks to the deposit insurance funds.

The AMA is highly complex and extremely expensive to implement. Moreover, given the wide range of variation in how banks are estimating risk inputs for the

comparatively mature discipline of credit risk measurement, it also must be acknowledged that estimates of capital requirements for operational risk capital will be, for the foreseeable future, of unknown usefulness. Rather than compromise the principle of bank-centric capital calculation because the unique features of the AMA force such compromises upon us, we would be more inclined to offer significant flexibility to any bank that is computing a capital requirement for operational risk, including reliance on data and analysis developed outside the insured bank, or allowing banks to use approaches simpler than the AMA.

In short, the tensions between the important principle of stand-alone bank capital calculation, and the costs and burdens of the AMA, can be resolved. There is room for substantial additional thinking in this area, and the FDIC is committed to working with our fellow regulators to arrive at a sensible solution that does not impose excessive burdens on U.S. banks or banking organizations.

Conclusion

The agencies stand at an important crossroads in the development of U.S. capital regulation. The considerations outlined in this testimony suggest to us that achieving an implementation of Basel II that will represent positive change for the U.S. financial system is contingent on several important factors. In brief, they are:

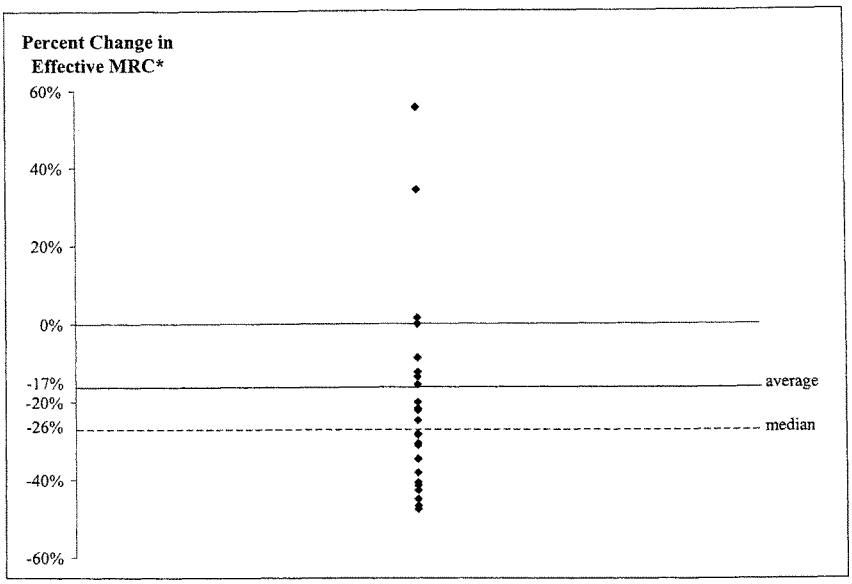
- Preserving a set of straightforward minimum capital requirements to complement the more risk-sensitive, but also more subjective, approaches of Basel II;

- Maintaining competitive equity; and
- Finding ways to achieve results under Basel II that are less extreme and more consistently applicable across banks.

The FDIC, like the other banking agencies, will proceed with the implementation of Basel II in an appropriately deliberative manner and with full consideration of the comments of all interested persons.

APPENDIX

QIS-4 Preliminary Change in Effective Minimum Capital Requirements of Participating Institutions: Basel I to Basel II



*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is preliminary data as of May 5, 2005 for the twenty-six participating QIS-4 institutions, and caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies plan additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.

QIS-4 Preliminary Change in Minimum Capital Requirements of Participating Institutions: Basel I to Basel II

Portfolio	% Change in Portfolio MRC	Median % Change in Port. MRC	Share of Basel I MRC	Share of Basel II MRC
Wholesale Credit	**(25%)**	**(24%)**	**44.3%**	**38.8%**
Corporate, Bank, Sovereign	(22%)	(30%)	33.9%	30.7%
Small Business	(26%)	(27%)	4.6%	4.0%
High Volatility CRE	(33%)	(23%)	1.8%	1.4%
Incoming Producing RE	(41%)	(52%)	4.0%	2.7%
Retail Credit	**(26%)**	**(50%)**	**30.5%**	**26.3%**
Home Equity (HELOC)	(74%)	(79%)	6.1%	1.8%
Residential Mortgage	(62%)	(73%)	11.1%	4.9%
Credit Card (QRE)	66%	63%	6.1%	11.7%
Other Consumer	(7%)	(35%)	6.0%	6.5%
Retail Business Exposures	(6%)	(29%)	1.2%	1.3%
Equity	11%	(9%)	1.3%	1.6%
Other assets	(12%)	(3%)	10.1%	10.4%
Securitization	(20%)	(40%)	7.9%	7.7%
Operational Risk			**0.0%**	**9.0%**
Trading Book	0%	0%	5.2%	6.0%
Portfolio Total	**(14%)**	**(24%)**	**100.0%**	**100.0%**
Change in Effective MRC*	**(17%)**	**(26%)**		

*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is preliminary data as of May 5, 2005 for the twenty-six participating QIS-4 institutions, and caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies plan additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.

TESTIMONY

Basel II Regulation: U.S. Market and Competitiveness Implications

Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.

Before the

Subcommittee on Financial Institutions and Consumer Credit

And

Subcommittee on Domestic and International Monetary Policy, Trade and Technology

U.S. House of Representatives

May 11, 2005

It is an honor again to appear before you to discuss the pending rewrite of risk-based capital rules and their potentially profound market and competitiveness impact. It is often tempting to let these rules reside in the technical workrooms to which their length, complexity and – most alarming – math – lead many to consign them. However, your Subcommittees and the leadership of the full Financial Services Committee recognized early how important these rules will be. You led the way with the first Congressional hearings in February, 2003 and a subsequent round last year, and you have also filed several detailed comments with the U.S. banking agencies. This has ensured that the policy impact – not just the technical workability of the Basel II rules – is getting carefully and urgently-needed consideration prior to implementation in the United States.

Before I begin my testimony, let me say that I am managing partner of Federal Financial Analytics, a consulting firm that focuses on federal legislation and regulation affecting financial services firms. We engage in a wide range of Basel-related projects, advising firms on the strategic impact of the proposals. I also head the Financial Guardian Group, which is deeply concerned about the proposed regulatory capital charge for operational risk.

In previous testimony before your Subcommittees and the Senate Banking Committee, I have suggested that the Basel II rules and, in particular, the way the U.S. proposes to implement them, will have serious, unintended competitiveness and risk-management consequences. The proposed operational risk-based capital charge alone could cost U.S. banks an additional $67 billion in regulatory capital – a cost that would be added to substantial implementation ones during the long delay before any of these additional costs would be offset by reduced credit risk-based capital. This is not to say that Basel I should be retained – it should not. Rather, it is to argue for a gradual approach to rewriting Basel II so that improvements are well-understood, implemented across the board and tested before additional refinements are made. The current effort to do a global, complete rewrite of the risk-based capital (RBC) rules that deals with almost every variation of all banking products around the world at one time is a classic instance of the perfect proving to be the enemy of the good.

This problem – best beating better – is of particular concern in the United States. As you know, the banking agencies on April 29 delayed Basel II implementation because of concerns raised during the most recent quantitative impact survey. This delay is also postponing release of the rewrite of Basel I intended to allay growing competitiveness concerns – concerns that, as you know, some in the agencies also seek to dispel by arguing that regulatory capital has little bearing on business decision-making. Despite the Basel II and Basel I rewrite delays, though, banks are being told in no uncertain terms to get ready for Basel II and decide if they want to opt in. Incredibly detailed guidance on even minor Basel II points is being issued although the entire rule remains up in the air. Frankly, this is the worst of all options – agencies are demanding readiness for a rule not yet written because of an effort to get all its details totally right while all of the market distortions from the current requirements remain unaltered.

The complexity of Basel II also makes it easy to miss an important point: for all that, the rules only redefine how risk weightings for assets are to be set. The definition of "capital" has been left for another day – indeed, people are even now talking about a Basel III that will take on this task. However, regulatory capital is, at its heart, a ratio of capital to assets and this means that it's important to get both right. A more simple approach to assets would permit an immediate review of capital. This would, in turn, permit recognition not only of reserves (already on the table), but also of factors such as tax carry-backs that provide hard cash to banks to offset losses.

Today, I will argue:

- There needs to be quick implementation of the well-understood, agreed-upon parts of Basel II for all U.S. banks – not just the big ones. If the U.S. lags Basel II adoption abroad – as now seems likely – this will pose a serious competitiveness threat to U.S. banks. Analysts abroad are already characterizing capital as the "weapon of choice" in bank consolidation. Of course, a "bifurcated" adoption of Basel II here in the U.S. will pose comparable competitiveness problems for banks left out of the new capital accord. If Basel II has meaning – and one must think regulators believe it does given the huge effort behind it and the billions it will cost – then it will meaningfully affect bank pricing and profitability, with concomitant competitiveness impact.

- A leverage standard is incompatible with risk-based capital requirements. It is understandable that banking agencies wish to leave one in place as the complex, untested Basel II models are introduced, and the agencies appear also committed to retention of the 10% RBC level that also defines a "well-capitalized" bank. However, the current leverage and prompt corrective action thresholds are far above the right capital ratios for low-risk institutions and well beyond ratios that make sense as safeguards during Basel II implementation. If these ratios are retained under Basel II, they then should be considerably reduced under the authority already possessed by the banking agencies.

- Recent studies have suggested that Basel II will lead to wide variability among bank RBC ratios, with some institutions seeing significant drops and others coming under far higher regulatory capital requirements. This is as it should be if the big reductions are at low-risk institutions. The underlying purpose of Basel II is to make regulatory capital promote safety and soundness. Thus, low-risk banks should see low RBC. Trying to "top off" Basel II with fixes to the formulas or additional capital charges like the proposed one for operational risk undermine its important goals. The large drops in capital at some banks in the recent quantitative impact survey must be understood in light of the limitations of that study (current strong economic conditions and the lack of stress testing, for example).

- The proposed operational risk-based capital charge is problematic not only because of its "topping off" role, but also because there is as yet no agreed-upon methodology to measure and manage operational risk. Thus, an RBC charge for it would be arbitrary and unduly costly. In addition, these costs would create perverse incentives against proven forms of operational risk management – disaster preparedness and contingency planning, for example. Recent surveys have shown that many banks have yet to even institute these urgent measures, and they should not be diverted from vital qualitative risk-management improvements into a quantitative exercise designed to make the Basel II numbers add up to 8%.

Finally, I would like to thank the Committee leadership for its hard work on legislation to ensure that the U.S. position in Basel negotiations reflects a consensus among our regulators. This year, you have again introduced legislation to ensure such a consensus and also that reports on key points are given to Congress before the Basel II rules are finalized. As the process continues, however, you may wish to consider revising the legislation to focus not only on international negotiations – now largely complete on Basel II – but also on the scope of the U.S. risk-based capital regulations. As I shall discuss in detail, these rules will drive decisions about which banks can offer what types of mortgages, small business loans and other critical financial services at what price where. Thus, despite the daunting technical nature of these rules, Congressional review and, if necessary, direction is essential.

I should like now to proceed to discuss each of the points noted above in detail. I have attached to this testimony a brief discussion of the general issues in Basel II and its timeline both around the world and in the United States.*

Moving From Basel I to Basel II: Leave No Bank Behind

Getting the risk-based capital rewrite right is essential for two reasons:

- For all its complexity, RBC has economic impact. The Office of the Comptroller of the Currency (OCC) has already reached a preliminary decision that the Basel II rules will have major economic impact, and it is right about this.

- If the rules are wrong and unintended competitive consequences ensue – small banks are swallowed by big ones or specialized banks are gobbled by diversified ones – a revision to the rules won't put the banking system back together. Once charters are gone or lines of business disappear, they cannot be quickly brought back to life. Thus, Basel II impact will be both very significant and long-lasting, like it or not.

* Much of this discussion is based on a study of the competitive impact of the operational risk-based capital rule prepared by Federal Financial Analytics on behalf of the Financial Guardian Group (copies of the study are available on request).

This go-slow recommendation is not, however, a no-go one. As indicated, Basel I is broken and needs to be revised. For all the suggestions that RBC has no competitive impact, Federal Reserve studies discussed in detail below at the start of the Basel rewrite argued that in fact it had major "arbitrage" implications. Low-risk assets have gone into the secondary market and high-risk ones have remained on bank balance sheets – the reverse of the incentives one would think supervisors would like to encourage for safety and soundness. Markets have also moved because regulatory capital treatment is easier on assets held in the "banking book" than on those held in the "trading book" – resulting in a bank competitive advantage over investment banks in key business lines. Basel II proposes to fix this, as well it should.

It is not necessary, though, to go immediately to the most technically advanced sections of Basel II to achieve its benefits. Indeed, too quick a move to these too-complex standards could have an array of unintended consequences – problems worsened by current moves in the U.S. to find ways to keep total regulatory capital numbers the same even as the RBC rewrite is implemented. The best way to end Basel I without the competitive and market consequences likely if the U.S. continues on its current course is to allow use here of the "standardized" Basel options – minus the operational risk-based capital rules – for all banks and savings associations. Bigger ones with more advanced systems can then elect the advanced internal ratings-based option over time, with supervisors learning more about this option and addressing the still unsolved problem of coordinating rules across national borders (the "home/host" problem) in an incremental way that limits sudden, unexpected shocks.

Cost Concerns

A long-established way to evaluate any regulatory proposal is to do a cost/benefit analysis. Let me start, therefore, with an evaluation of the costs of Basel II's operational risk-based capital (ORBC) charge and Basel II's overall implementation costs. Many in the industry hope that all of these costs will be offset by reductions in credit RBC for low-risk institutions. However, as discussed below, this may not occur because the U.S. plans to retain arbitrary leverage and other regulatory capital thresholds. Some have suggested that all of these costs and the limits on RBC reductions mean that Basel II will have no adverse competitive impact on small U.S. banks that stay under Basel I. If so, one has to ask why everyone is bothering with Basel II – if it's simply topped back up to Basel I levels with these costs, why impose it at all? Regulators must in fact expect that Basel II will still be meaningful, making these costs significant and the potential competitive impact important.

Academics have concluded that, "the ORBC charge could cost U.S. banks $50 - 60 billion without any positive benefit and with many negative implications."[1] Financial

[1] *Sizing Operational Risk and the Effect of Insurance: Implications for the Basel II Capital Accord*, Andrew Kuritzkes and Hal Scott, June 18, 2002. This determination assumes: Total Risk Weighted Assets (RWA) for the U.S. banking system are approximately $5.9 trillion. The total regulatory capital requirement is

Guardian Group calculations confirm the very high cost of the ORBC charge. Assume that, as expected, the top twenty-five U.S. banks will either be required to come under the Basel II rules or will opt into them. These banks currently hold $517 billion in regulatory capital.[2] The Basel Committee has estimated that a Pillar 1 ORBC charge could add approximately 13% in regulatory capital.[3] Based on this, the current ORBC proposal would cost U.S. banks approximately $67 billion.

The high cost of the ORBC requirement comes atop the considerable one associated with Basel II implementation. One recent study estimates the total implementation cost for Basel II will exceed $11 billion by the end of 2005.[4] For the credit risk portion alone, the Financial Services Authority estimates that the UK banking industry will need to spend several hundred million pounds on just information technology systems.[5] Broken down by individual institution, consulting firms Mercer, Oliver, Wyman and Accenture both believe costs could run as high as $200 million per bank.[6] These costs will be particularly significant for banks using the advanced models – the only ones, of course, permitted in the United States.

These costs argue strongly that:

- There should not be a regulatory capital charge for operational risk. As discussed in more detail below, operational risk is better offset with effective risk management, and this high cost will divert urgently-needed resources from this incomplete effort.

- The final Basel II framework should justify its high implementation costs by permitting full recognition of risk in risk-based capital. Should this lead to fears that capital at low-risk banks will drop too far too fast, then gradual implementation – which will reduce the implementation cost – should ensue.

How Regulatory Capital Affects Competitiveness

As Basel II has become more controversial, especially in the face of criticism at Congressional hearings, some advocates of the revised RBC standards have started to argue that regulatory capital matters little to the competitiveness of banks or the pricing of the products they offer. These assertions are striking in light of all of the rhetoric from bank regulators at the start of the Basel rewrite. Then, regulators argued that the old rules needed to be reformed precisely because differences between regulatory and economic capital (the amount of capital demanded by the market) were creating areas of "arbitrage"

---

fixed at 8% of RWA. The proposed 12% calibration would imply $56 billion of regulatory capital for operational risk.

[2] Third quarter, 2004 data. See www.ffiec.gov.

[3] *Third Quantitative Impact Survey of the New Basel Accord*, Bank for International Settlements, Basel Committee, October 1, 2002.

[4] *Impact of the New Basel Accord*, Christoph Sidler and Gabriel David, EDS, January 2003.

[5] *Banks face heavy IT bill over Basel II*, Deborah Hargreaves, Financial Times, January 27, 2005.

[6] *Basle II Prompts Strategic Rethinks*, Euromoney, Thomas Garside and Christian Pederson, December 2002; and *Basel II Requires a Billion Rand*, Acumen, January, 2003.

– that is, banks were changing business plans to take advantage of areas where RBC was lower than economic capital requirements and exiting lines of business where RBC was too high. As the Bank for International Settlements has found, "[The influence of regulatory capital on competitiveness of banks] was in fact one of the key factors behind the international efforts to harmonize capital standards in the 1980s."[7] Ending capital arbitrage was also key to the entire Basel II process, as the then-Chairman of the Basel Committee, former New York Federal Reserve Bank President William McDonough made clear when he said, "[T]he financial world has changed dramatically over the past dozen years, to the point that the Accord's efficacy has eroded considerably. Its broad brush approach to differentiating credit risk encouraged banks to undertake regulatory arbitrage transactions."[8]

Regulatory arbitrage has been a significant factor in U.S. and global financial markets since Basel I was finalized in 1988, making it clear that any differences between regulatory and economic capital left after Basel II will similarly restructure the markets. The Bank for International Settlements[9] and a Federal Reserve staffer[10] found that there were four main types of regulatory capital arbitrage after Basel I: "cherry picking," securitization with partial recourse, remote origination and the use of indirect credit enhancements. They also noted the use of credit derivatives/synthetic securitizations and short-term lending, a finding confirmed by others.

For example, a group of international regulators affiliated with the Basel Committee confirmed the importance of regulatory capital in business decisions when it concluded that, "The second motive for [credit risk transfer or CRT] activity is that regulatory capital requirements on credit risk are often above the economic capital the market requires to bear the risk. Banks cited reducing regulatory capital as a motive for their participation in CRT markets…"[11] Some have suggested that securitization resulting from Basel I incentives will offset Basel II competitiveness problems resulting from the mortgage requirement, but it is far more likely to be restructured to reflect changed RBC incentives in a fashion that alters the current competitive landscape with adverse implications for smaller banks.

As the BIS and Federal Reserve staff papers also noted, banks can reduce their regulatory capital requirements merely by originating and holding credit risk positions on their trading books, again an increasingly significant market phenomenon with sweeping impact on the relative competitiveness of commercial versus investment banks. The Basel Committee has recently proposed a rewrite of Basel II to correct this, showing that competitiveness implications are a major component of RBC drafting.

---

[7] *Bank Capital Regulation in Contemporary Banking Theory: A Review of the* Literature, João A C Santos, Bank for International Settlements, Working Paper No 90, September 2000.
[8] *Update on the Major Initiative to Revise the 1998 Capital Accord*, William McDonough, Federal Reserve Bank of New York, June 19, 2000.
[9] *Capital Requirements and Bank Behavior: Impact of the Basle Accord*, Bank for International Settlements, Basel Committee, April 1999.
[10] *Emerging Problems with the Basel Capital Accord: Regulatory Capital Arbitrage and Related Issues,* David Jones, Journal of Banking and Finance 24, 2000.
[11] *Credit Risk Transfer,* Bank for International Settlements, The Joint Forum, October 2004.

Because regulatory capital drives profit expectations, it is also a key determinant of which banks win or lose in those business lines. When banks hold more regulatory capital, as will be the case for those remaining under Basel I in the U.S., their ability to compete against the banks receiving large credit risk regulatory capital reductions under Basel II is seriously affected. Similarly, diversified banks – the biggest of the big – can afford to engage in a line of business with unduly high RBC because this cost can be cross-subsidized by drops in RBC in other business lines. A specialized bank, in contrast, cannot offset the impact of inappropriately high RBC, making it difficult to continue as a free-standing franchise. If taken over by a large diversified institution, concentration and systemic risk increases. If taken over by a non-bank competitor, systemic risk may increase because the assets are now held by a less thoroughly supervised entity or organization.

Capital Could Compel Consolidation

Consistent with assertions that regulatory capital doesn't determine product decisions – incorrect, as demonstrated above – some Basel II advocates have also argued that the new rules will have no impact on merger-and-acquisition (M&A) activity. This assertion is also incorrect. And, it's an even more risky one than arguments that regulatory capital doesn't affect line-of-business decisions. After a bank exits a line of business because of RBC anomalies, it may be years before it re-enters the business, if it can do so at all. However, once a bank franchise is gone, it's gone for good. Thus, any errors in bank RBC that result in consolidation mean that the banking system will stay as restructured, even if major policy objectives are jeopardized by this consolidation.

Although Basel II's impact may be speculative in the United States, it is already evident in the European Union. There, the standardized options will be in place on the first of January, 2007, and markets are already reacting. As one analyst has found:

> "Basel II can be a strategic weapon: SCH's proposed takeover of Abbey provides the first hint....This means that for a period of time, capital adequacy has the potential to be a new battleground for competition far more than it has been in the past – the weapon of choice is the efficiency of capital....Basel II starts to look like a catalyst for increased M&A activity."[12]

Consolidation in the U.S. banking system is hard to dispute when it is the result of natural market forces like improved technology that creates economies of scale. However, it is quite another thing when consolidation results from – or worse – is even driven by, artificial regulatory action. In 2002, an analyst predicted that, "As a result of Basel II...consolidation in the banking industry will accelerate from the pace it has followed for

[12] *Q-Series ®: Basel II – New Capital Guidelines,* UBS Investment Research, August 2004.

the past 20 years. From 1980 to 2000, the top 10 firms doubled their market share from 20 percent to 40 percent. We believe that in the next five years, the top 10 firms will again double their market share, this time to 80 percent."[13]

This consolidation creates potentially serious systemic risk, since the failure of one large bank could suddenly throw financial markets into disarray and create a huge drain on the federal deposit insurance system. A fundamental axiom of portfolio theory is that diversification reduces risk, and it thus follows that the more banks there are in the United States, the less potential systemic risk. To the degree that aspects of Basel II promote consolidation, therefore, the RBC system will have the unintended consequence of increasing risk – not reducing it as hoped.

Consolidation in the U.S. banking system could also have adverse implications for industry customers. The U.S. has long had thousands of small banks and savings associations, in sharp contrast to the European Union, Canada and Japan. These nations, along with most others outside the United States, have banking systems dominated by as few as five giant banks. As a result, these systems consistently lag the U.S. in innovation, especially in developing products and services aimed at average consumers – in particular, those previously underserved by traditional commercial banks. Local economic needs are also far less well served in countries with a few nationwide banks than in the United States, where small banks in rural areas are often the bulwark of regional economic development. When banks consolidate and exit local markets, unregulated entities – finance companies, for example – often enter with potentially adverse consequences on the quality and cost of both credit and other bank products and services.

Risk-Based Capital Should Reflect Real Risk

As noted, a major goal – indeed, perhaps the major goal – of Basel II is to align regulatory and economic capital. Quantitative impact surveys – with all their methodological questions – are showing that this will in fact occur. Banks with low-risk books will get RBC well below the current 8% minimum, although some of the very low numbers are likely to rise a bit as stress-testing is added to the equation. Banks with high-risk books, in contrast, are seeing RBC hikes – sometimes significant ones. However, because the overall risk profile of the industry now is low, the overall QIS results show significant potential RBC reductions. This is as it should be in a meaningful RBC framework worth all the implementation costs noted above.

This is not, though, as it will be in the United States. Here, we have two unique regulatory capital requirements: a "leverage" standard that mandates a 5% capital ratio against all on-balance sheet assets regardless of risk and a 10% "prompt corrective action" (PCA) RBC ratio that banks must hold to be deemed "well capitalized." Thus, if a low-risk bank – one that held nothing but U.S. Treasury obligations or gold, for example – ran its Basel II numbers and arrived at an RBC ratio of, say, 1%, it would still have to hold the 5% and 10% ratios.

[13] *Financial Services Sector Braces for Basel II*, CIO Magazine, Andy Efstathiou, July 2002

This will clearly have adverse competitive impact. No other nation requires these ratios, so their low-risk banks around the world will realize Basel II benefits. Importantly, these unique U.S. ratios also do not promote the safety-and-soundness incentives argued by their advocates. A high-risk bank would still be "well capitalized" in the U.S. if it meets these ratios regardless of whether it otherwise complied with the higher Basel II RBC requirements. Banks that stayed under Basel I, of course, would not even be subject to any higher RBC, permitting high-risk institutions to portray themselves as sound even though risk-based capital in fact was far below economic allocations or market expectations.

Some have argued that these leverage and prompt corrective action ratios, while problematic, offset much of the competitiveness concerns for small banks noted above. They suggest that big banks will have to hold lots more capital than Basel II would require so that differences between big and small institutions will fade. However, big banks long ago learned to balance RBC in diversified portfolios to make it possible both to win competitive advantage where RBC is low and still comply with the leverage and 10% requirements. A big bank can, for example, add a layer of very high-risk assets – toxic ones, some would say – to capture Basel II advantages for the bulk of its assets. This is far more difficult for small or specialized institutions and it isn't good for any of them.

A more compelling defense of the leverage and PCA requirements is the fear that Basel II relies on untested models based on capital estimates drawn during the best of times. Under current law (12 U.S.C. 1831o(c)), the agencies must set leverage and PCA thresholds, but the law gives them total flexibility to do so, except with regard to the ratios that define "critically undercapitalized" banks. In conjunction with Basel II, the agencies should review current ratios and reset them to ensure that the leverage and PCA requirements do not undermine the risk incentives intended under Basel II or U.S. bank global competitiveness against institutions not subject to comparable requirements.

Indeed, the leverage and PCA standards could also have adverse domestic impact. As discussed in more detail regarding the operational risk-based capital requirement, large U.S. banks expected to come under Basel II compete against non-banks in many lines of business. Some have argued that adverse competitive impact will be offset by a new RBC standard set by the Securities and Exchange Commission (SEC). However, the SEC standards are wholly voluntary and, in any case, apply only to the biggest investment banks that own large broker-dealers. Even then, though, the SEC standard does not offset the adverse competitive impact of the banking agency leverage and PCA requirements.

The 2004 SEC rule[14] creates "supervised investment bank holding companies" and "consolidated supervised entities." Arguably, these firms are subject to Basel II. However, there are major differences between the SEC's rules and those contemplated by the U.S. banking agencies. Importantly, there will be no leverage requirement, nor any

[14] 17 C.F.R. Parts 200 and 240.

threshold determining who is "well capitalized" on the RBC front – firms under the SEC regime need meet only the "adequate" capital thresholds applicable in the EU. They may also use the less advanced Basel II options not allowed for big U.S. banks. These differences ensure that the SEC approach will be less onerous for those large competitors subject to it.

Operational Risk Should Come Out

Under Basel II, operational risk (OR) is defined as:

> "The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. The definition includes legal risk, which is the risk of loss resulting from failure to comply with laws as well as prudent ethical standards and contractual obligations. It also includes the exposure to litigation from all aspects of an institution's activities. The definition does not include strategic or reputational risks."[15]

This approach raises many questions – the first of which is how a regulatory capital charge can be assigned to a type of risk for which even the definition is complex, subjective, and controversial. Many in the industry believe that OR definitional and measurement techniques are not yet developed enough to support a set capital charge. For example, one industry expert recently noted, "It's absolutely true that we are still in the infancy of understanding everything about operational risk."[16] Even the BIS's own Risk Management Group and Committee on the Global Financial System contends that OR cannot be defined or accurately measured[17] and attempts to do so have already distracted significant industry and supervisory resources from urgently needed improvements. The Group of Ten concurs, noting, "[T]he term 'operating risk' is a somewhat ambiguous concept that can have a number of definitions.... Operating risk is the least understood and least researched contributor to financial institution risk."[18] Finally, the ratings agency Standard & Poor's also weighed in, noting that, "The lack of consistent industry-wide operational loss data represents a large obstacle to the development of a statistical methodology that could carry the analysis beyond the qualitative and enable regulators to measure and compare OR across banks."[19]

---

[15] *Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital*, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, July 2, 2003.

[16] *For Basel Opt-Ins, It's Time to Gather Data*, Damien Paletta, American Banker, January 21, 2005, quoting Charles Taylor, director of operational risk at the Risk Management Association.

[17] *Credit Risk Transfer,* Committee on the Global Financial System, Bank for International Settlements, January 2003 and *Sound Practices for Management and Supervision of Operational Risk*, Basel Committee on Bank Supervision, Risk Management Group, February 2003.

[18] *Report on Consolidation in the Financial Sector*, Group of Ten, January 2001.

[19] *Basel II: No Turning Back for the Banking Industry*, Standard & Poor's, Commentary and News, August 26, 2003.

Regardless of the criticism, the Basel Committee has gone forward and finalized its OR proposal. The Committee offers three different approaches. The "basic indicator" and "standardized" approaches assign a simple charge for OR based on the gross income of the institution. These approaches will not be allowed in the U.S. due to warranted concerns over their validity. Instead, U.S. regulators will apply only the advanced measurement approach (AMA), which will require banks to develop highly-complex and rigorously-tested internal models to calculate the capital charge. Although significantly more sophisticated than the other two approaches, this one also has its problems, including its limited recognition of risk mitigation (e.g. contingency planning and insurance) and the reliability of its complex internal models.

It is very difficult, if not impossible, to quantify the risks posed by events such as rogue traders, terrorist attacks and natural disasters. How does one quantify the risk posed by a 9/11-type attack or a tsunami? As a result, many in the industry, as well as those in the supervisory community have questioned the Accord's quantitative approach to OR. Specifically, the following concerns have been raised by the regional Federal Reserve Banks:

- The Federal Reserve Bank of St. Louis has noted that, "Operational risk is even more difficult to estimate [than other risks] because historical losses are not well-documented."[20]

- The Federal Reserve Bank of Chicago filed a comment with the Basel Committee on a previous draft of the framework which makes clear the numerous problems with the proposed version of ORBC. It states, "Definitions of operational risk categories continue to evolve, and while some banks and organizations have begun collecting data, this process has not been systematized."[21]

- The Federal Reserve Bank of Richmond also filed a comment noting that OR can be, "[A] difficult risk to quantify and can be very subjective."[22]

- The Federal Reserve Bank of San Francisco has argued, "[A] key component of risk management is measuring the size and scope of the firm's risk exposures. As yet, however, there is no clearly established, single way to measure operational risk on a firm-wide basis."[23]

---

[20] *Basel II Will Trickle Down to Community Bankers, Consumers*, William R. Emmons, Vaye Lskavyan, Timothy J. Yeager, *The Regional Economist*, April, 2005

[21] *Federal Reserve Bank of Chicago Response to BIS Capital Proposal*, Federal Reserve Bank of Chicago, May, 2001.

[22] *The New Basel Accord Second Consultative Paper, January 2001*, Federal Reserve Bank of Richmond, May 30, 2001.

[23] *FRBSF Economic Letter*, Federal Reserve Bank of San Francisco, January 25, 2002.

- The Foreign Exchange Committee, which is sponsored by the Federal Reserve Bank of New York, concludes that "[U]nlike credit and market risk, operational risk is very difficult to quantify."[24]

These Federal Reserve Bank conclusions have been buttressed by academic research. A Cambridge University study determined that, "No data now exists for evaluation of operational risk events similar to Barings, Daiwa or LTCM. The possibility of effectively pooling such data across institutions seems unrealistic for many years to come and is statistically invalid without further research."[25] Furthermore, U.S. scholars have stated, "Private insurance and process regulation would be more effective than capital requirements for regulating operational risk."[26]

In fact, the industry has historically managed operational risk through future margin income (FMI), pricing and reserves, as well as through insurance. In the case of legal risk, which is discussed further below, U.S. banks are required to establish significant reserves to offset potential penalties. Similarly, natural disasters or manmade ones, to the extent foreseeable, are offset with insurance – a proven form of risk mitigation demonstrated in the Basel Committee's Risk Management Group's operational risk loss data collection exercise.[27] While insurance is partially recognized as a potential mitigant by Basel, pricing, reserves and FMI – which cover the overwhelming majority of operational losses – are not. Thus, the Accord fails to recognize that operational risk is already well handled through various techniques and without threat to solvency.

The Basel Committee and the U.S. regulators have acknowledged the point noted above for credit risk. Like operational risk, expected losses related to loans or investments are first addressed through reserves and, then, earnings. Credit RBC is also offset by credit risk mitigation, including guarantees. The final Basel II rules and the pending U.S. proposal will only require that credit risk capital be held for unexpected losses, allowing insurance, reserves, FMI and pricing to account for expected ones. This creates a serious inconsistency within the Basel rules – credit risk-based capital covers only unexpected loss, but the proposal mandates ORBC for both expected and unexpected losses despite the fact that expected losses are handled in the same fashion in both of these risk areas. A senior Fed official recently admitted that few of the banks participating in the U.S. regulators' "loss data collection exercise"[28] (a necessary premise for the ORBC rule) have the information Basel II will require.[29] The *American Banker* has also noted that operational risk management lags far behind the Basel II requirements, with only about half of surveyed banks even having a defined OR management function, let alone all the

[24] *Management of Operational Risk in Foreign Exchange*, The Foreign Exchange Committee, March 2003.
[25] *Operational Risk Capital Allocation and Integration of Risks*, The Judge Institute of Management, Cambridge University, Elena Medova, 2001.
[26] *The Regulation of Operational Risk in Investment Management Companies*, Charles W. Calomiris and Richard J. Herring, Investment Company Institute – Perspective, September 2002.
[27] *The 2002 Loss Data Collection Exercise for Operational Risk: Summary of Data Collected*, Bank for International Settlements, Basel Committee, March 2003.
[28] *2004 Operational Risk Loss Data Collection Exercise*, Federal Financial Institutions Examination Council, October 2004.
[29] *For Basel Opt-Ins, It's Time to Gather Data*, Damien Paletta, American Banker, January 21, 2005.

data required to comply with the rule.[30] Regulators have defended the rule in spite of this gap on the grounds that Basel II is a strong incentive to improve OR management, but only 7% of banks in the survey cited the coming capital rule as a reason they are beginning to improve operational risk management. Instead, they cited other regulatory pressures and market demand.

Because Basel II includes legal risk in its definition of OR, U.S. institutions will be particularly hard hit. Banks operating in the United States generally face a far broader range of regulation outside the banking area than their foreign competitors. This includes laws regarding tort liability, discrimination, suitability and others that have no EU or Japanese equivalent. Since the U.S. legal system poses the highest litigation risk of any G-10 country, U.S. banks will likely be required to set aside far more capital for OR than their foreign competitors. They will be forced to do this despite the fact that U.S. securities laws already require holding reserves for material legal risks and there is no evidence that these have ever adversely affected the safety and soundness of any U.S. bank. As Credit Suisse notes, "Firms with significant activities in the United States could be put at a competitive disadvantage due to the increased litigation risk resulting from the U.S. judicial system."[31]

International competitiveness issues are not the only concerns raised by the ORBC requirement. Although Basel II outside the U.S. covers all major financial institutions, within the U.S. it can only be applied to insured depositories and certain of their holding companies. Thus, bank/non-bank competitiveness is an additional and very significant problem – or, perhaps, an opportunity if viewed from the non-bank perspective.

Non-banks are major competitors in key business lines covered by ORBC. For example:

- 37 of the top 50 asset managers, 74%, are non-banks;
- 5 of the top 10 wealth managers, 50%, are non-banks;
- 4 of the top 9 transfer agents, 44%, are non-banks
- 7 of the top 10 defined contribution plan service providers, 70%, are non-banks; and
- 9 of the top 10 401(k) plan administrators, 90%, are – yet again – non-banks.

How to Handle Operational Risk

As noted, the proposed RBC charge for operational risk is problematic from a methodological and competitiveness perspective, as well as raising the serious risk of becoming a perverse incentive to effective OR management. OR management is in fact critical to safe and sound banking – and it has become even more so in these post-9/11 days when threats to critical financial infrastructure have come from frightening new sources.

---

[30] *A Diverse Industry Struggles with Op Risk,* Rob Garver, American Banker, May 3, 2005.
[31] *Basel II Implications for Banks and Banking Markets*, Credit Suisse Economic & Policy Consulting, July 29, 2003.

The first and most important way to ensure effective OR management is a sound set of supervisory standards ("Pillar 2" in the Basel framework). These can and should include an economic capital allocation for those forms of operational risk for which such a charge is meaningful, and disclosures can provide useful information to investors on this allocation and on overall OR management (adding "Pillar 3" market discipline to the mix).

Advocates of the current Basel rules have argued that the AMA is, in effect, a "Pillar 1.8." However, the fact that the AMA excludes most risk mitigation and is based on untested, debatable data belies the certainty that must underlie a regulatory capital charge. The more flexible framework finally included in the Basel rules also poses serious problems given the U.S. system of tough enforcement for institutions that do not pass muster as "well capitalized." Importantly, no such standard applies elsewhere, with supervisors providing considerable latitude in the way RBC is measured and in what happens when totals fall below required amounts. Supervisors should get considerably more experience with ORBC and ensure that international standards are comparable before U.S. banks are subject to a charge that – even while still at variance with economic capital – can carry a serious wallop.

Basel Basics

The Basel Accord is an international agreement governing the capital adequacy of banks operating globally. The Switzerland-based Bank for International Settlements (BIS) first established these international capital standards, generally referred to as "Basel I," in 1988. Due to certain inadequacies in the first Accord, namely that it did not accurately reflect the diverse risks taken by banks, the BIS's Basel Committee in 1998 decided to undertake a comprehensive rewrite. The new Basel Capital Accord, "Basel II," uses a new three-Pillar architecture to achieve this goal. It includes:

- Pillar 1: minimum regulatory capital requirements;
- Pillar 2: enhanced supervisory review of an institution's capital adequacy and internal assessment process; and
- Pillar 3: market discipline through public disclosure of various financial and risk indicators.

Last summer, the Basel Committee released the final version of this new framework, now the blueprint for implementation in individual countries.[32] The framework significantly revises the capital requirements for various risks, potentially increasing or decreasing them significantly for individual institutions. The Basel Committee, however, has calibrated the overall Basel II framework in hopes of keeping the current 8% risk-based capital (RBC) ratio in place for the banking industry as a whole. A series of quantitative impact surveys (QIS) have occurred to test if the RBC rules will in fact keep this 8% number intact for the industry as a whole, with wide variability expected for individual institutions. The results of the fourth QIS caused the banking agencies to delay U.S. implementation plans. A fifth QIS, to be undertaken by international banks, is expected early next year.

For the first time, the Basel RBC standards will apply not only to banks, but also to bank parent companies. In addition, the new rules will, for the first time, impose regulatory capital charges for operational risk (Basel I only covers credit and market risk). Interestingly, Basel II continues to count interest-rate risk under Pillar 2 rather than impose a capital charge, even though it is far easier to measure than operational risk. As shown in the U.S. S&L disaster as well as in the isolated failure of a number of banks, interest-rate risk – in sharp contrast to operational risk – is a proven cause of major banking crises.

Under Basel II, institutions are allowed three approaches to assessing credit risk and three for assessing operational risk. However, the Accord is only a framework, and national supervisors may diverge from it, in some cases significantly. For example, the U.S. regulators (the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation) are only allowing institutions to use the most advanced approaches to operational and credit risk.

[32] *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, Bank for International Settlements, Basel Committee, June 26, 2004.

Timeline

The Basel Committee intends its new framework to be implemented at year-end 2006.[33] However, the more complex advanced approaches will be delayed for an additional year. U.S. regulators initially pushed for the delay to ensure that the final U.S. rules can reflect any changes warranted by their studies of the Accord's impact. Banks using the advanced options will need to run them parallel with Basel I for one year and then apply floors on the amounts of capital that must be held. These floors are expressed as a percentage of the capital that would be required under Basel I. The following chart details how this will work:

	From year-end 2005	**From year-end 2006**	**From year-end 2007**	**From year-end 2008**
Less Advanced Approaches	Parallel Calculation	95% floor on capital reductions	90% floor	80% floor
Advanced approaches for credit and/or operational risk	Parallel calculation or impact studies	Parallel calculation	90% floor	80% floor

U.S. regulators are moving on a different timetable than other countries. Already moving more slowly than other regulators, the U.S. agencies had planned to release a Basel II proposed rule in June along with the planned Basel I rewrite (possibly issued as an advance notice of proposed rulemaking). However, on April 29, 2005, the agencies announced that this schedule has had to be revised. The U.S. QIS4 found wide variations in regulatory capital, leading agencies to question whether their information on the rules is correct and/or if the rules will permit too much of an RBC reduction.

The agencies now plan to have Basel rules in place by January 1, 2007, which is consistent with the Basel schedule for the advanced options, but they also note that this could well change if ongoing studies and negotiations lead to a significant delay in the Basel II proposed rule.

[33] The EU is pushing their start dates back one day to January 1, 2007 and January 1, 2008 rather than December 31, 2006 and December 31, 2007 to avoid extra costs for banks whose financial years end on December 31.

EMBARGOED
until May 11 at 10:00 am

Statement

of

Richard M. Riccobono, Acting Director
Office of Thrift Supervision

concerning

Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study

before the

Subcommittee on Financial Institutions and Consumer Credit
and the
Subcommittee on Domestic and International Monetary Policy,
Trade and Technology

Committee on Financial Services
U. S. House of Representatives

May 11, 2005

Office of Thrift Supervision
Department of the Treasury

1700 G Street N.W.
Washington, D.C. 20552
202-906-6288

Statement required by 12 U.S.C. 250:

The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

Testimony on Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study
by
Richard M. Riccobono
Acting Director, Office of Thrift Supervision
before the
Subcommittee on Financial Institutions and Consumer Credit
and the
Subcommittee on Domestic and International Monetary Policy, Trade and Technology
of the
House Financial Services Committee

May 11, 2005

I. Introduction

Good morning, Chairman Bachus, Chairwoman Pryce, Ranking Members Sanders and Maloney and members of the Subcommittees. Thank you for holding this important hearing on Basel II and for your continued interest in this issue.

I particularly want to thank you, Chairman Bachus, for your legislative efforts to establish a mechanism for developing uniform U.S. positions on issues before the international Basel Committee on Banking Supervision (BCBS). In addition, Mr. Chairman, thank you for including in your bill, H.R. 1226, the United States Financial Policy Committee For Fair Capital Standards Act, a provision supporting Office of Thrift Supervision (OTS) representation on the BCBS. While OTS is an active participant both domestically and internationally (including on numerous international subcommittees) in the Basel II process, we remain the only U.S. banking agency without formal representation on the BCBS. This anomaly is more glaring given that OTS is currently the only U.S. regulator to have been accorded "equivalency" status by the European Commission under the European Union's financial conglomerates directive.

I appreciate the opportunity to testify today about the application of the Basel II capital framework in the United States (or, more formally, the International Convergence of Capital Measurement and Capital Standards: a Revised Framework). It was two years ago that OTS was last here to talk about Basel II. Although we are more than two years from its projected implementation, now is a good time to provide an update on the approach to capital contemplated

by Basel II and the status of regulatory convergence, as well as the issues that U.S. financial institutions are expected to face under the Basel II framework.

II. Overview and Background of the Basel Process

A. Basel I

Before discussing where we are today, it is instructive to review the Basel I Accord to provide a background for understanding Basel II.

Basel I, agreed to and issues by the BCBS in 1988, was a set of capital principles designed to strengthen capital levels at large internationally active banks, and foster international consistency and coordination.[1] Basel I addressed only the largest, internationally active banks in G-10 countries and encouraged countries outside the G-10 to adopt the principles for their banks that were operating internationally. The themes of Basel I, however, were intended to apply to all banking organizations of any size and activity.

While OTS did not participate in developing Basel I, we applied it to the institutions we regulate, as did the other three federal banking agencies (FBAs)—the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC). Throughout the implementation of Basel I, the four FBAs developed risk-based capital standards consistent with the underlying principles, but with modifications intended to enhance risk sensitivity and conform to the unique needs of the U.S. banking system.

When Basel I was issued, the BCBS recognized that it was only a start, and that more refinement would take place over time. As financial instruments, systems and products became more complex, the BCBS began designing a new regulatory capital framework. This framework, Basel II, incorporates advances in risk measurement and management practices, and attempts to assess capital charges more precisely in relation to risk. The international agreement (framework or mid-year text) articulating these Basel II principles was issued in June 2004.

---

1 The BCBS identified two fundamental objectives at the heart of its work on regulatory convergence under Basel I. As the BCBS stated, first, "the new framework should serve to strengthen the soundness and stability of the international banking system; and [second,] the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks."

B. Basel II

OTS supports the concepts, principles, and stated goals of Basel II, and we are committed to implementing a prudent and sensible framework for its implementation in the United States. Although the BCBS developed a far more detailed and risk-sensitive capital adequacy framework in Basel II than in the original Basel I principles-based accord, it did not stray from the original Basel I objectives. In fact, the BCBS expanded upon these objectives as a guide to its efforts in producing the current proposal. In particular, the BCBS observed that Basel II should:

- Continue to promote safety and soundness and at least maintain the current overall level of capital in the system;
- Continue to enhance competitive equality;
- Establish a more comprehensive approach to address risk;
- Contain approaches to capital adequacy that are appropriately sensitive to risk; and
- Focus on internationally active banks, although its underlying principles should be suitable for application to all banking organizations.

These goals continue to guide the Basel II process both domestically and internationally.

There are many reasons our U.S. banking system should move forward to a more logical, risk-based framework for evaluating capital adequacy in those institutions that would be bound by Basel II, as well as those that choose to opt into it. At the same time, it is important to identify ways to improve Basel I for the thousands of institutions that will not be required to adopt and will not choose to adopt Basel II. We believe that these objectives are not mutually exclusive, but rather mutually dependent in order to prevent potential competitive inequities between Basel II adopters and non-adopters.

As you are aware, the international effort on Basel II has been extensive. The June 2004 mid-year text provides for a comprehensive framework for the convergence of national rule-making efforts and approval processes to continue in participating countries, and for banking organizations to complete their preparations for Basel II implementation.

Basel II encompasses three Pillars—minimum regulatory capital requirements (Pillar 1), supervisory review (Pillar 2), and market discipline (Pillar

3). Under Pillar 1's proposed new minimum regulatory capital requirements, institutions must calculate capital requirements for exposure to both credit and operational risk. This is a fundamental change from Basel I, which effectively aggregated all types of risk into a simple "four-bucket" approach that applied a one-size-fits-all "risk-weighting" to assets in each bucket.[2]

The Basel II international framework evaluates various risk types separately, and each risk type may be measured by different methods. In many other countries, credit risk will be measured by either a standardized approach or one of two internal ratings-based approaches under the framework. The two ratings-based approaches, which involve the development of individualized models at each institution, are the Advanced Internal Ratings-Based (AIRB) approach and the "Foundation" approach. Similarly, the centerpiece of the operational risk component also permits use of an internal model, the Advanced Measurement Approach (AMA). There are also other simpler approaches to measuring operational risk under the international framework.

Early in the domestic Basel II process on Pillar 1, decisions were made to adopt in the United States only the AIRB approach for credit risk and the AMA approach for measuring operational risk. Proposals to date have required institutions with more than $250 billion in assets or $10 billion in foreign exposures to adopt these advanced Basel II approaches. Other financial qualifying institutions may elect to adopt the framework at their discretion.

Basel II's supervisory review under Pillar 2 is designed as a way for banking supervisors to attain better overall risk management and internal controls at the institutions we regulate. This includes supervisory review of an institution's own assessment of its capital adequacy positions relative to overall risk, rather than solely of the minimum capital requirements under Pillar 1. Risks not explicitly accounted for under Pillar 1, such as interest rate risk, credit risk concentration, and strategic risks, are dealt with under Pillar 2.

Pillar 3, Basel II's market discipline component, imposes public disclosure requirements on institutions. These are intended to allow market participants to better assess key information about an institution's risk profile and level of capital. The public disclosure requirements are aimed at creating transparency regarding risks undertaken by financial institutions, thus, creating a robust market-based discipline.

---

[2] Under Basel I, assets are accorded a zero, 20 percent, 50 percent, or 100 percent risk-weighting depending on their relative risk within predetermined asset categories.

There have also been a series of structured and coordinated information gathering exercises conducted internationally—Quantitative Impact Studies (QIS). These data collections, including QIS 1, 2, 2.5 and 3, have all been conducted in a collaborative framework with results shared by the individual BCBS participants. For example, in 2001, the BCBS conducted two data collection exercises, QIS 2 and QIS 2.5, to gather information to assess whether the BCBS had met its articulated Basel II goals. These studies gathered data from a wide range of banks in the G-10 and beyond to examine the differing risk profiles of banks and the extent to which credit risk mitigation is utilized. Similarly, in October 2002, the BCBS launched another comprehensive field test, QIS 3, that focused on the impact of the Basel II proposals on banks' minimum capital requirements.

One of the subjects of today's hearing, QIS 4, was not a collaborative international effort, but largely a U.S. exercise (with limited international participation) to estimate the proper calibration of Basel II minimum capital requirements for U.S.-based Basel II implementers. QIS 4 involved field tests based on the revised framework set forth in the 2004 mid-year text. In addition, it involved the first attempt by the FBAs to collect data based on the most comprehensive guidance and instructions for the implementation of Basel II in the United States available to date.

As recently reported, the QIS 4 survey showed a wide variation in required capital. Chief among these was a significant capital reduction from the application of Basel II to mortgage lenders, accompanied by significantly increased minimum capital requirements for institutions concentrating in lending activities having significantly higher inherent credit risks. While the wide range of divergence was not expected, the fact that mortgage lending is generally a safer proposition than higher credit risk lending activities should not be surprising—particularly since QIS 4 was an exercise in measuring credit risk.

By their very nature, conservatively managed mortgage lenders typically have substantially lower credit risk exposure than lenders concentrating in other retail lending activities. A major risk for mortgage lenders, interest rate risk, is also greatly reduced by the presence of sound and prudent interest rate risk management practices, including access to the secondary mortgage market. Finally, the underlying collateral of the real property on which they lend secures mortgage lenders. A reduction in the capital requirement for only the credit risk of mortgages was not, therefore, a total surprise.

C. Basel II in the United States

1. Interagency Efforts So Far

The four FBAs have been working with the banking and thrift industry to implement Basel II based on a relatively aggressive timeframe. While some may suggest that we have been at this for a long time, the reality of the Basel II process is that there has been substantial time dedicated by the FBAs to Basel II policy development, but comparatively much less time spent, so far, on Basel II implementation issues.

Under the currently proposed timeframes, a non-binding "parallel run" of the Basel II framework is projected to begin in 2007, with full implementation targeted for 2008. During the parallel run phase, institutions seeking to implement the Basel II framework would also be required to continue to comply with the existing Basel I requirements.

In an effort to meet the proposed timeframes, the FBAs have cooperated on several joint interagency efforts. These include various issuances to implement the Basel II framework domestically, including guidance to assist financial institutions in developing systems and processes to perform the numerous, highly complex calculations required under the Basel II framework.

In August 2003, the FBAs published a notice and request for comment on several pieces of supervisory guidance addressing corporate lending activities—"Draft Supervisory Guidance on Internal Ratings-Based Systems for Corporate Credit" and "Supervisory Guidance on Operational Risk Advanced Measurements Approaches for Regulatory Capital." Accompanying these was an Advanced Notice of Proposed Rulemaking (ANPR) proposing the adoption of the AIRB approach for measuring credit risk and the AMA approach for measuring operational risk (see above discussion under "Basel II"). Significantly, the ANPR did not include provisions for adopting the standardized or foundation approaches outlined in the Basel II framework.

In October 2004, the FBAs published for notice and comment supervisory guidance on retail lending programs—"Internal Ratings Based Systems for Retail Credit." Standards set forth in this and the previously issued guidance are being updated and expanded to address issues raised in industry and public comments.

On January 27, 2005, the FBAs issued an interagency statement addressing U.S. implementation of the Basel II framework and the qualification process for the AIRB approaches to credit risk and operational risk. Pursuant to that

guidance, U.S. institutions planning to adopt the Basel II framework are encouraged to prepare implementation plans, including a self-assessment and identification of areas that require additional work.

Most recently, in April 2005, an international proposal was issued covering certain trading-related exposures and double default effects. Comments on the proposal are due the end of May. Pending the outcome of comments received on the proposal, the FBAs anticipate incorporating the internationally agreed upon principles into the proposed domestic regulations.

2. Interagency Efforts Going Forward

a. The NPR

The FBAs are currently working on a Notice of Proposed Rulemaking (NPR) as a precursor to issuance of a rule implementing the Basel II framework in the United States. While the domestic timeline anticipated publication of a NPR sometime in mid-2005, this is being reassessed pending a thorough analysis of the QIS 4 data. At present, the FBAs are still working toward issuance of a final rule in mid-2006, which is a critical timing issue for U.S. financial institutions to have sufficient lead-time to prepare for the parallel run that is scheduled to begin in 2007. This, of course, is contingent on satisfactory resolution of the QIS 4 issues.

It is also important to note that OTS and OCC are subject to Executive Order 12866, which requires executive agencies to determinate whether a proposed rule is a "significant regulatory action." OTS has determined that the NPR will by a significant regulatory action based on the potential effects of the rule. Thus, OTS is required to prepare a regulatory impact analysis of the NPR, including an analysis of the need for regulatory action, the costs and benefits of the NPR and alternative approaches, and the impact on competition among financial services providers. Pursuant to the Executive Order, the NPR and accompanying regulatory impact analysis will be submitted to the Office of Management and Budget for review prior to publication of the NPR.

b. Anticipated Supervisory Guidance

In conjunction with issuance of an NPR, the FBAs also plan to issue proposed guidance consolidating the previously issued guidance on retail, corporate and operational risk. The consolidated guidance is expected to include issues not previously addressed, including securitization, credit risk mitigation, equity exposures and various wholesale transactions, such as repurchase agreements. Industry reaction and comment on the consolidated supervisory

guidance will be critical since it will be the first iteration of U.S. regulatory policy on some subjects. In addition, it will be the first opportunity for the industry to judge the adequacy of the guidance based on the standards enumerated in the NPR. The FBAs plan to make additional adjustments to the guidance after receiving industry comments and to ensure consistency with the final rule.

c. Basel I Rewrite

In recognition of the enhancement of risk measurement tools since the enactment of Basel I, OTS has been a strong advocate of revising and modernizing the existing Basel I domestic capital standards. Our view is that the revision of Basel I should encompass meaningful reforms, but avoid imposing costly analytical processes on smaller banks and thrifts. For example, modifying the existing rule with more accurate risk-weights allocated to a wider range of asset buckets would substantially improve the current Basel I framework. Applying commonly used risk criteria for identifying different levels of risk would further enhance the existing framework. This would provide for a more granular, risk-sensitive system of determining appropriate levels of capital. We strongly support amending the existing domestic Basel I regulations simultaneously, or in close proximity to, rulemaking efforts implementing Basel II. It may also be worthwhile to explore amending Basel I sooner, particularly if Basel II timeframes are pushed back.

d. The QIS 4 Survey

In the midst of ongoing development of U.S. implementation of the AIRB approach for Basel II, the FBAs met in the spring of 2004 to design the basic data forms, as well as instructions and questionnaires, for QIS 4. As a participant in this process, OTS focused particularly on the impact on mortgage lending, the predominant activity of the thrift industry,[3] and on gathering data on home equity lines of credit, a significant growth area for banks and thrifts.[4] It appears from the preliminary data that our interest in adding a separate section for home equity lines of credit to the survey was warranted.

On June 26, 2004, the FBAs issued a press statement outlining the objectives and timing of QIS 4 and inviting institutions interested in participating

---

[3] Significantly, mortgages and mortgage-backed securities currently constitute over 34 percent of assets of the entire banking industry.

[4] Home equity lending for the banking and thrift industry currently stands at roughly $491 billion, exceeding the industry's on-balance-sheet credit card assets by more than 22 percent.

in the survey to express that interest to their supervisor. The initial response to this solicitation included a broad range of institutions, from small regional banks that wanted to learn more about Basel II, to the largest and most sophisticated internationally active banks expected to implement Basel II.

On October 29, 2004, the FBAs released the QIS 4 instructions, questionnaire, and a preliminary workbook with numerous tabs for data on each of the primary asset categories covered under Basel II. As the questionnaire noted, the agencies recognized that the data and systems relevant to AIRB would still be in development at many institutions, and understood that institutions, whatever their preparation, would be assembling estimates on a best efforts basis.

Twenty-seven institutions provided survey responses. One institution supplied only its operational risk capital requirement, and thus is not included in the summary data. The FBAs had subsequent conversations with the participants, primarily to address internal inconsistencies in the data. Many respondents resubmitted their data, making some minor and often major changes, a process that continues.

III. Issues Raised by QIS 4

As previously highlighted, based on a preliminary analysis of the QIS 4 data, there appears to be substantial variation in the respondents' Basel II capital results. The results of the QIS 4 exercise suggest that Basel II is very much a work in progress in the United States, both for the FBAs and the institutions that will implement it. It is entirely appropriate at this juncture to ask whether we may be moving too quickly and, if so, to reassess and determine how to adjust the timelines we have been operating under to implement Basel II.

Taking into account the substantial cautions about interpreting the QIS 4 survey results, the aggregate data show a significant decrease in the amount of capital required for credit risks associated with all but one category of wholesale and retail lending, including large capital reductions for mortgage and home equity lending.[5] This is an especially important result because of commercial banks' concentration in mortgage-related assets.[6]

---

[5] Based on the preliminary results of QIS 4, required minimum capital for wholesale credit categories dropped an average of 23.7 percent, including a more than 41 percent reduction for income producing real estate. Similarly, required minimum capital for retail credit categories declined an average 26.9 percent, with a 75 percent reduction for home equity lending, but with a 60 percent increase in required minimum capital for credit card lending activities. See attached survey results.

[6] Since 1995, commercial banks have increased their holdings of residential-related mortgages 174 percent in real dollars, from $991 billion to $2.72 trillion. As a percentage of assets, commercial bank holdings of

It is important to note that mortgage lending typically includes a significant degree of interest rate risk. This is a critical element in evaluating appropriate capital levels even under Basel II; however, interest rate risk was not addressed in the QIS 4 survey. The survey only addresses the credit risk component of the mortgage capital requirement. For prime mortgages, credit risk is generally fairly low. Thus, the declines in capital for mortgages measured by QIS 4 most likely result from the low credit risk of various individual mortgage portfolio lenders that participated in the survey. We cannot confirm this, however, absent further analysis.

In recognition of the substantial interest rate risk associated with many forms of mortgage lending, OTS has developed a rigorous interest rate risk model. The model requires an institution to hold sufficient capital—depending on the degree of its exposure to potential interest rate shifts—to offset interest rate risk exposure.[7] It is our experience, working with our interest rate risk model for more than a decade, that savings associations have modified interest rate risk-taking behavior based on information and tools provided by the model. How interest rate risk is ultimately treated under Basel II is an important issue for OTS and the thrift industry, as well as banks that focus on mortgage lending activities.

Another noteworthy result from QIS 4 is the sizable reduction in required capital for home equity lines of credit. Since the end of 2000, home equity lines of credit on institution balance sheets have grown by an extraordinary 325 percent, to $491 billion. This is due, in large part, to the low interest rate environment that we have experienced recently for mortgages and mortgage-related products. The aggregate survey results may well reflect just the most recent experience, and not the full economic cycle risk parameters required under Basel II.

In fact, we are very concerned that the imbedded potential risks of home equity lending exceed what the results from the last few years have shown. As a

---

residential-related assets have increased 40 percent, from 23.0 percent of assets in 1995 to 32.3 percent of assets today. By contrast, thrifts have increased their holdings of residential-related mortgages in real dollars by 62 percent, but as a percentage of assets thrift holdings are actually 4 percent lower than in 1995, from 75.6 percent of assets in 1995 down to 72.5 percent of assets today.

7 OTS's interest rate risk model assesses the portfolio interest rate risk exposure at a given institution and provides a report to the institution and to OTS examiners. Where there is too much interest rate sensitivity in the portfolio relative to the market value of portfolio equity, an OTS examiner will work with the institution to develop strategies to mitigate the risk. These include better matching of the effective durations of assets and liabilities, interest rate hedging strategies, reducing portfolio leverage, or a combination of these. To date, the OTS model has been reasonably effective in controlling interest rate risk at the institutions we regulate.

result, we are currently working with the other FBAs on additional interagency supervisory guidance on home equity lending.

The QIS 4 survey has also demonstrated that the banking industry is in various stages of preparedness in implementing an AIRB approach to capital. This is to be expected, particularly since the FBAs are also in the process of developing and articulating guidance on what the AIRB approach means to institutions from a regulatory perspective as well as how institutions should proceed to implement it. The difficulty of this process is that it is very much interdependent and, ultimately, requires data to validate the underlying assumptions as well as to make the necessary adjustments to implement a workable model. That is, institutions' ability to validate their risk management processes and the FBAs' ability to supervise them depends greatly on developing rich and robust data.

Given what we have learned so far from the QIS 4 exercise, prudential supervision suggests that a longer implementation period is needed to gain the necessary data and confidence we require before implementing such a major change in our capital framework. It is also important that we continue to move forward to attempt to remain abreast of our international supervisory counterparts. This is a difficult challenge, but OTS remains committed to working with the other FBAs on the Basel II process with a goal of timely implementation of a sound capital framework—for the Basel II implementers as well as the vast majority of institutions that will continue to operate under Basel I, albeit with substantial improvements from the Basel I rewrite process. We urge institutions to continue to develop their internal risk systems and data gathering efforts, and ask the patience and support of Congress and the industry to assist us in this difficult, but worthwhile, challenge.

IV. Public Policy Concerns with Basel II

A. Timing

Although refining our risk measurement and management systems by implementing a more risk sensitive capital framework is an important objective, we must do so mindful of a broader public policy context. Longstanding capital adequacy standards combined with a well-established and highly respected supervisory structure that includes regular on-site examinations have delivered a banking system that is healthy and robust. While OTS supports the Basel II effort, we do so with an equally important objective of doing no harm to our existing banking system.

Improved risk monitoring technologies available to institutions have propelled advancements in capital requirements and dramatically improved capital allocation efficiencies. Moving to a more advanced and risk sensitive capital framework is necessary in order to take full advantage of advanced risk measurement techniques. It is important to approach this exercise cautiously and systematically in order to provide for sufficient time to study and debate the best course of action in the United States for implementing the complexities of the advanced models-based capital system of Basel II.

The movement to Basel II currently contemplated for our largest and most sophisticated institutions is a dramatic paradigm shift from the current principles-based Basel I risk buckets. Ideally, this should be an evolutionary process that provides ample time for policy development, real-world testing, and the gradual migration of institutions to the new system based on their demonstrated readiness. Developing a capital system that encourages better risk measurement and management practices is, of course, the required first step in this process, but the lure of "big thinking" should not overwhelm practical considerations of "how will this really work." Most importantly, institutions should not be permitted to adopt any new capital framework absent clear evidence that they are ready to do so.

While we would like to have had the benefit of experience afforded by other interim approaches to improved capital risk measurement and management, those options may no longer be available if we are to remain in sync with international Basel II implementation. Significant uncertainty is inherent in the most advanced approaches of Basel II, as well as with the uneven state of readiness at our largest banking organizations—and the regulatory and supervisory framework we have developed for them.

At this time, all agree that there is much to be done before the advanced approaches of Basel II can be adopted in the United States. The FBAs must minimize significant unintended consequences and—with the stakes so high—it is far better to get it right than to get it done in some arbitrarily set timeframe. We believe that, as a matter of good public policy, the Basel II timeframes should be viewed as guidelines, not hard targets. It is our intent to pursue Basel II implementation in the United States with this notion firmly guiding our future actions.

B. Competitive Considerations

The goal of more risk-sensitive capital requirements is as important for small community banks as it is for large, internationally active institutions. Achieving greater risk sensitivity for one part of the banking system and not the

whole will invariably create competitive distortions. While the ideal of global regulatory convergence of capital standards is extremely important, we must not ignore its effects and potential impact on U.S.-based institutions that are not operating internationally.

At issue is whether we maintain comparable (although not necessarily identical) capital standards for all banking institutions with respect to lending activities that have the same risk characteristics. Although our largest institutions should receive capital treatment commensurate with their ability to reduce risk via diversification and technology, community banking organizations should not be competitively disadvantaged by being left behind, mired in the relatively risk-insensitive Basel I system. Competitiveness issues raised by Basel II necessitate an across-the-board examination of capital standards for all our banks and thrifts. This provides an opportunity to re-examine the appropriateness of the Basel I risk-based capital system for our community institutions, and to take the necessary steps to reduce potential competitive inequities.

OTS is pleased that an initiative we have advocated for years, the so-called Basel IA rewrite, has ripened into a commitment by all the FBAs to propose modifications to Basel I for U.S. banking organizations that do not adopt Basel II. The goal of this initiative is to achieve greater risk-sensitivity without undue complexity. We believe this can be accomplished by increasing the available asset "risk-buckets," and by applying commonly understood criteria for assessing the relative risk of various loan types. In hindsight, perhaps it would have been productive to pursue this strategy for all U.S. institutions some time ago. Modifying Basel I in this manner may have provided a useful interim step along the road to Basel II, and relieved some of the current time pressure on implementing the models-based approaches of Basel II.

C. Interest Rate Risk

As previously described, Basel II includes minimum regulatory capital requirements under Pillar 1 that require institutions to calculate capital requirements for exposure to credit and operational risk. Pillar 1 does not, however, include specific capital requirements for interest rate risk. The framework addresses interest rate risk as part of market risk in Pillar 2. OTS believes that this significant risk, especially important in mortgage products, should be addressed by the FBAs consistently. If the FBAs adopt final regulations maintaining this Pillar 2 construct for interest rate risk, it will be important to study this issue carefully and prepare comprehensive interagency guidance on how we expect this risk to be measured and managed.

D. Leverage Requirements, Prompt Corrective Action, and other Safeguards

Any discussion of Basel II is incomplete without a discussion of the interrelationship between leverage and risk-based requirements. Unfortunately, the issue has spawned a substantial amount of dialogue about whether there should be a leverage requirement. No one seriously disputes this notion.

While the increased risk sensitivity offered by Basel II is intended to align risk-based capital requirements more closely with a banking organization's own internal capital allocation, the principal objective of a leverage requirement is different. Fundamentally a backstop to protect the federal deposit insurance funds, the leverage requirement places a constraint on the maximum degree to which a banking organization can leverage its equity capital base.

In the late 1980's, Prompt Corrective Action (PCA) was instituted in response to the need for more aggressive and timely supervisory intervention in the face of stressed and declining capital levels. Currently, the FBAs define a "well-capitalized" institution as having Tier 1 (i.e., core) capital of 5 percent, "adequately capitalized" is set at 4 percent, "under-capitalized" at less than 4 percent, "significantly under-capitalized" at less than 3 percent, and "critically under capitalized" at less than 2 percent.

Bearing in mind that these are institution-wide levels (as opposed to the asset segment measurements of risk as prescribed by Basel II), the potential conflict with Basel II is readily apparent. If one believes that Basel II will achieve greater risk sensitivity, then an institution with a concentration of low risk assets will be constrained by the leverage ratio, and its capital will not be risk sensitive. Conversely, leverage may impose no restraint on a relatively high risk institution, but that institution would be constrained, presumably, by an effective risk-sensitive standard.

The current one-size-fits-all approach to a leverage ratio runs at cross-purposes with Basel II. Leverage treats all assets on the balance sheet identically. It provides too little incentive to manage risk for both very low and very high credit risk institutions. In a more complex financial world than was envisioned in the 1980's, today's expanding universe of off-balance-sheet activity goes untouched by existing leverage requirements. Thus, a regulatory capital system with a risk-insensitive leverage ratio that becomes the principal binding capital constraint on financial institutions, rather than a backstop measure, would be significantly flawed. Furthermore, such a system may perversely motivate low

credit risk lenders to pursue riskier lending—one of the unintended consequences mentioned earlier.

OTS remains committed to defining an appropriate leverage ratio for all types of lenders. It is important for the FBAs to retain the broad authority granted through PCA to move swiftly and effectively when banking organizations approach distressed capital levels. We take issue, however, with those who argue that this leverage ratio is inviolate for healthy and robust institutions, with superior risk measurement and management.

As a regulator, it is easy to ask for more capital through a simple construct. It is harder to harmonize leverage, PCA and risk-based concepts in an increasingly complex system, maintaining the vitality of the safety and soundness goals of both, without unduly burdening healthy banks and thrifts. Ideally, the requirements should work in unison. As we progress in improving our risk-based capital system, for all our banking organizations, it is incumbent upon us to pay close attention to its ongoing relationship with our leverage requirements.

No capital approach is, by itself, an adequate answer to ensuring safety and soundness. Similarly, layering in a variety of permanent counter measures, such as arbitrary floors and multipliers, into the Basel II capital requirements to offset capital reductions in low credit risk portfolios, undermines the overarching goal of creating a more risk-sensitive framework. It is important to get each facet of our capital regime right, and that may take more time and more commitment to those purposes.

V. Issues for Further Consideration

Numerous issues raised by QIS 4 require us to take sufficient time to complete a thorough analysis of its results. The potential impact of Basel II on our banking system requires us to move forward at a measured pace and not sacrifice accuracy for speed.

Among the issues for consideration are whether Basel II should be modified to allow for other available options, including the creation of transitional steps before proceeding to full Basel II implementation. This includes preserving flexibility to change existing timeframes to allow for supervisory qualification and validation, and to permit institutions more time to operate under parallel standards as well as to implement Basel II at their own pace.

Completing the Basel I rewrite should also proceed in a timely manner, even if it outpaces work on Basel II; although we believe that, for competitive

reasons, the Basel I rewrite should not fall behind the pace of the Basel II process. Like the Basel II process, the Basel I rewrite should proceed at a pace that ensures success in designing a sound capital system that can be sustained and improved upon as necessary in the future.

Another important, if not critical, consideration is addressing the leverage requirement and the Basel II floors as a complete, seamless and integrated framework in the United States. In this regard, we may also want to consider addressing interest rate risk in Pillar 1, rather than retaining it in Pillar 2.

The course of our deliberations on all these issues should continue to be guided by the important goals of Basel II, including updating and modernizing U.S. capital standards in support of global convergence and to encourage better risk management, improved safety and soundness, and greater efficiency and competitiveness.

VI. Conclusion

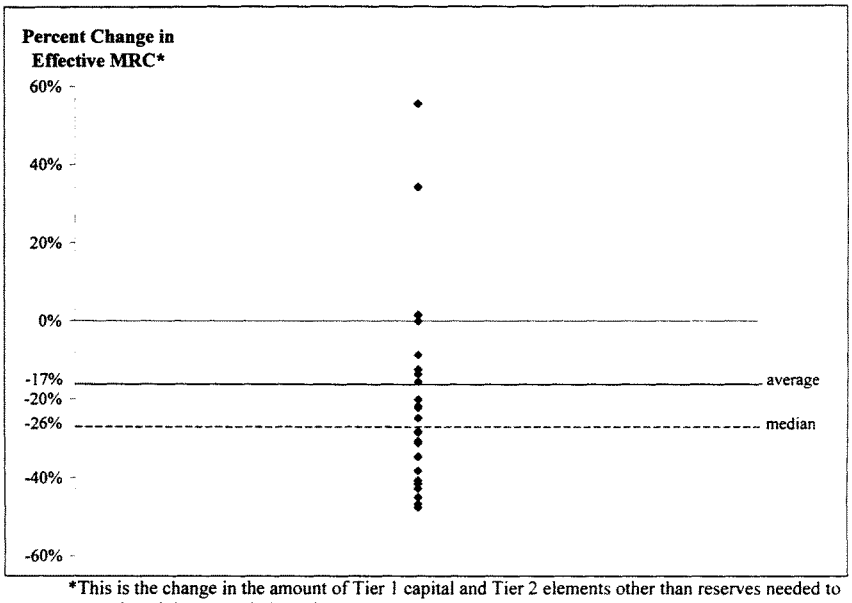
OTS supports the goals and objectives of Basel II and we are committed to implementing a more risk-sensitive capital framework for all our regulated institutions. While it is important that the United States continue to move forward on Basel II, we should proceed in a cautious, well-studied and deliberative manner. We should also be prepared to take any steps necessary to accomplish the goals of Basel II, even if that means delaying implementation of the new framework.

It is critical that all interested parties, including the industry, Congress and the regulators, continue an active, open and thorough dialogue regarding the issues and timing of Basel II. We will continue to work together with Congress, the other FBAs, and with our BCBS colleagues in the international community to ensure that we get Basel II right, as opposed to just "on time."

Thank you, Chairman Bachus and Chairwoman Pryce for holding this important hearing, and for the continued interest and hard work of the Members on these important issues. We will be happy to provide any additional information that you may require regarding the ongoing Basel II and Basel I rewrite processes.

Attachment 1

Preliminary Change in Effective Minimum Capital Requirements of Participating Institutions: Basel I to Basel II



*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is preliminary data as of May 5, 2005 for the twenty-six participating QIS-4 institutions; caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies plan additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.

Attachment 2

Preliminary Change in Minimum Capital Requirements of Participating Institutions: Basel I to Basel II

Portfolio	% Change in Portfolio MRC	Median % Change in Port. MRC	Share of Basel I MRC	Share of Basel II MRC
Wholesale Credit	**(25%)**	**(24%)**	**44.3%**	**38.8%**
Corporate, Bank, Sovereign	(22%)	(30%)	33.9%	30.7%
Small Business	(26%)	(27%)	4.6%	4.0%
High Volatility CRE	(33%)	(23%)	1.8%	1.4%
Incoming Producing RE	(41%)	(52%)	4.0%	2.7%
Retail Credit	**(26%)**	**(50%)**	**30.5%**	**26.3%**
Home Equity (HELOC)	(74%)	(79%)	6.1%	1.8%
Residential Mortgage	(62%)	(73%)	11.1%	4.9%
Credit Card (QRE)	66%	63%	6.1%	11.7%
Other Consumer	(7%)	(35%)	6.0%	6.5%
Retail Business Exposures	(6%)	(29%)	1.2%	1.3%
Equity	11%	(9%)	1.3%	1.6%
Other assets	(12%)	(3%)	10.1%	10.4%
Securitization	(20%)	(40%)	7.9%	7.7%
Operational Risk			**0.0%**	**9.0%**
Trading Book	0%	0%	5.2%	6.0%
Portfolio Total	**(14%)**	**(24%)**	**100.0%**	**100.0%**
Change in Effective MRC*	**(17%)**	**(26%)**		

*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is preliminary data as of May 5, 2005 for the twenty-six participating QIS-4 institutions; caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies plan additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.

Testimony of

America's Community Bankers

on

"Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study"

before the

Subcommittee on Financial Institutions and Consumer Credit
and the
Subcommittee on Domestic and International Monetary Policy, Trade and Technology

of the

Financial Services Committee

of the

United States House of Representatives

on

May 11, 2005

William J. Small
Chairman, President & CEO
First Defiance Financial Corp.
Defiance, Ohio
and
Member, Board of Directors
America's Community Bankers
Washington, DC

Chairmen Bachus and Pryce, Ranking Members Sanders and Maloney, and members of the Subcommittees, my name is Bill Small. I am Chairman, President and Chief Executive Officer of First Defiance Financial Corp., a $1.3 billion public savings and loan holding company located in Defiance, Ohio, and Chairman and Chief Executive Officer of its bank subsidiary, First Federal Bank of the Midwest, a federal savings bank. First Federal Bank is a community financial institution serving Northwest, Ohio, where it currently operates 25 full-service banking offices. The primary business lines of the bank are consumer loans and banking services, with a focus on single-family residential mortgage loans, and commercial lending services primarily to small businesses. Although we serve primarily a rural area in Northwest Ohio, we do compete head to head through our market area against many large national banks including Bank One, Key Bank, Wells Fargo, and National City, as well as super regionals such as Fifth Third Bank.

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. I have also served on the Federal Reserve Board's Thrift Institution Advisory Council (TIAC) for the three years ending in 2004, and in 2004 was the president of TIAC. Thank you for this opportunity to testify on Basel II and its impact in the United States. An announcement by the bank regulators about the most recent quantitative impact study for Basel II shows the importance of this hearing and Congressional oversight over this process.

The 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 will remain subject to Basel I.

ACB has expressed concern for several years 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 are concerned 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. This is why it is extremely important that the bank regulatory agencies work cooperatively together in analyzing and addressing the myriad of issues that must be addressed before Basel II is implemented in the United States.

We appreciate the monitoring and oversight role that Congress intends to fulfill, as contemplated in legislation recently proposed by Chairman Bachus and Ranking Member Maloney. There is an appropriate role for Congress to play here in light of the tremendous importance of capital requirements to the safety and soundness and economic health of the banking industry.

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 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 should 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 I, 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 in 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 proposed, more risk sensitive capital regime.

Capital requirements should treat similar risks comparably from institution to institution to avoid creating competitive inequities. The banking regulators report that the most recent quantitative impact study that they conducted about Basel II's impact in the United States showed evidence of

material 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% 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. The study showed that institutions that can use an internal ratings-based approach to determine capital and that have primarily a retail portfolio may see their minimum capital requirements reduced significantly. These same large banks compete head-to-head with community banks in the retail area. Retail lending, particularly residential mortgage lending, is the 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. The fact is that no one can really know what the competitive impact of a bifurcated system will be at this point in time.

While nobody can say with certainty at this time what the impact will be, one can assume that it 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 that borrower the same competitive interest rate that can be 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 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, 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 I 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.

Changes To Basel I

In recent public forums and in written Basel II implementation plans, the bank regulators have committed to reviewing Basel I and issuing an Advanced Notice of Proposed Rulemaking addressing possible changes to the framework sometime this summer. 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 more risk-sensitive capital requirements should be available.

ACB has advocated in its letters to the banking regulators and in previous testimony before the Subcommittee on Financial Institutions and Consumer Credit 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 I 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.

Another alternative would be for the bank regulators to 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.

The bank regulators have listened to our comments and suggestions and have agreed to take a new look at Basel I with the goal of making capital requirements more reflective of each bank's actual risk levels. It is important that the agencies work cooperatively in this effort to revise Basel I and that input be solicited from all affected parties We would encourage the agencies to form an advisory group of bankers to participate in the process and hold public roundtables on these very important issues. ACB will be actively engaged in this process and is willing to assist the regulators in any way we can to develop a reasonable approach.

Proposed Legislation

While we expect the regulators to work cooperatively in revising Basel I and implementing Basel II, we support the legislation sponsored by Chairman Bachus and Ranking Member Maloney. The legislation, among other things, would provide a potential role for the Treasury Secretary and require a unified U.S. position on Basel II. We believe that a role for the Secretary of the Treasury in these matters may be appropriate at this stage of the process. The significant revision of capital requirements for the first time since 1988 will have a major impact on all U.S. banking organizations. It is essential that it be done correctly, with the views of all interested parties being heard and considered. The revision of capital requirements would affect a large part of the U.S. economy and must be done with the safety and soundness of the banking industry, and the well being of the economy in general, always in mind. The Treasury Secretary, tasked with the responsibility of overseeing the U.S. financial markets and the economy generally, could play an important role in this process.

We also support the oversight role of Congress contemplated by the legislation. It is important that Congress is kept apprised of developments in this area and that the agencies report on the impact that changes to the capital requirements would have on the banking industry. We would caution, however, that this oversight role be exercised in a flexible manner so that the banking agencies can continue to negotiate efficiently with their global partners.

We also support the proposal to give the Director of the Office of Thrift Supervision equal representation with the other three U.S. bank regulators in Basel. We believe it is essential for the OTS to have a formal role at Basel because of its status as the primary federal regulator for approximately 1000 banking institutions and over $1 trillion in assets, and regulator of holding companies with foreign operations and/or parent companies. Giving the OTS a voice in the Basel implementation process also will help assure that international bank supervision policies do not inadvertently harm residential lending in the United States.

Finally, we strongly agree with the provisions in the legislation that require the banking agencies to analyze several listed factors, including the cost and complexity of Basel II and the competitive impact of its implementation in the United States. We believe that these factors should be analyzed by the agencies and reported to Congress for careful consideration before Basel II is implemented in the United States.

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. While we expect the banking agencies to work cooperatively together in determining how Basel II should be implemented in the United States and suggesting appropriate changes to Basel I, we do not oppose the Treasury Secretary playing a role in this process and believe that Congress should oversee and monitor these activities.

We thank Chairmen Bachus and Pryce and the rest of the Subcommittee members in giving us 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.

For Release Upon Delivery
10:00 a.m., May 11, 2005

TESTIMONY OF

JULIE L.WILLIAMS

ACTING COMPTROLLER OF THE CURRENCY

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

and the

SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE AND TECHNOLOGY

of the

COMMITTEE ON FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

May 11, 2005

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Introduction

Chairwoman Pryce, Chairman Bachus, Congresswoman Maloney, Congressman Sanders, and members of the Subcommittees, thank you for inviting the Office of the Comptroller of the Currency (OCC) to participate in this hearing on the U.S. implementation of the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," generally known as the Basel II Framework, and on proposed legislation H.R. 1226, entitled "United States Financial Policy Committee for Fair Capital Standards Act." I welcome the opportunity to participate in these important discussions.

My written statement covers five principal areas. First, I will provide a brief review of events and actions that have occurred to date, in order to provide perspective and context to my discussion of where we currently stand. Second, I will explain the current status of the U.S. Basel II implementation process, with particular emphasis on the preliminary analyses of quantitative information that we obtained from a number of large U.S. institutions in the past few months. Third, I will describe the next steps in the implementation efforts of the U.S. agencies, focusing on efforts to better understand the likely effects of the Basel II Framework as we develop domestic regulatory proposals. Fourth, I will review the current status of Basel proposals and industry preparations for the advanced measurement approaches for operational risk. Finally, I will offer comments on H.R. 1226 and its proposed new structure and process for interagency deliberations and international negotiations within the Basel Committee on Banking Supervision.

At the outset, I want to highlight three commitments that are central to our on-going analysis and implementation of the Basel II Framework: first, an open rule making process in which comments are invited and considered, good suggestions are heeded, and legitimate concerns are addressed; second, a reliable quantitative analysis prior to adoption of a rule, through which we can assess the likely impact of Basel II on the minimum regulatory capital requirements of our banks; and third, a prudent implementation in which we make well reasoned and well understood changes to bank capital requirements and incorporate in those changes appropriate conservatism.

Background

In June 2003, principals of the U.S. banking agencies testified before the Subcommittee on Financial Institutions and Consumer Credit on the work of the Basel Committee on Banking Supervision (Basel Committee) to revise the 1988 Capital Accord – work that was ultimately to become the Basel II Framework. The 1988 Accord, referred to as Basel I, established the framework for the risk-based capital adequacy standards applicable to internationally active commercial banks in all of the G-10 countries, and most other banking authorities around the world have adopted it. U.S. banking and thrift agencies have applied the 1988 framework to all U.S. insured depository institutions. By the late 1990s, however, it became evident that there were weaknesses in the Basel I framework. In particular, the relatively simple framework was becoming less appropriate for the increased scope and complexity of the banking activities of our largest banking institutions. In response, the Basel Committee commenced an effort to revise Basel I and move towards a more risk sensitive capital regime. As we said in the June 2003 hearing, the OCC firmly supports the objectives of the Basel Committee and believes that the Basel II Framework constitutes a sound conceptual basis for the development of a new regulatory capital regime. As we also noted in that hearing, however, we must better understand the practical effects of the implementation of such a new regime before we move forward.

In the nearly two years since that hearing, much has transpired in the Basel Committee, among the U.S. agencies, and within the U.S. banking industry. Let me briefly recap some of the critical activities during this period.

In July 2003, the U.S. agencies published an advance notice of proposed rulemaking (ANPR), based largely on the Basel Committee's third consultative paper (CP-3). The ANPR provided a description of proposed revisions to current capital regulations, while seeking comment on outstanding or contentious issues associated with the proposal. The ANPR also requested information on the cost of implementing the proposal, and sought comment on the competitive implications in both domestic and international markets for banks of all sizes, in part to help us assess and comply with certain procedural requirements of Executive Order 12866 (discussed below). In conjunction with the ANPR, the banking agencies also issued for comment draft

supervisory guidance articulating general supervisory expectations for banks seeking to implement Basel II-compliant methodologies for the Advanced Measurement Approach (AMA) to operational risk and Advanced Internal Ratings-Based Approach (AIRB) for corporate credits.

On June 26, 2004, the Basel Committee published the Basel II Framework, which incorporated significant changes from its earlier proposals, many of which were identified through comments on CP-3, the ANPR, and analyses of a quantitative impact study conducted by the Basel Committee known as QIS-3. Through the publication of the Framework, the members of the Basel Committee sought to secure some measure of international convergence on the risk-based rules applicable to internationally active banks. To facilitate harmonization in national implementation efforts, the Basel Committee also established common timelines for the adoption of the Basel II Framework. As it relates to the AIRB and AMA elements, the Basel II Framework would be available for implementation on January 1, 2008, with a trial "parallel run" period commencing on January 1, 2007.

It is important to recognize that even when adopted by the Basel Committee, the Basel II Framework will not apply to U.S. institutions unless and until the U.S. banking agencies take action, especially including the adoption of regulations, to implement it. Accordingly, on the same day as the publication of the Basel II Framework, the U.S. banking agencies published a Joint Release describing U.S. efforts to implement the Basel II Framework. Reflecting principles described in and comments received on the ANPR, the June 26, 2004 Joint Release described the agencies' plans to incorporate the AIRB and AMA into regulations and supervisory guidance for U.S. institutions. These plans were designed to ensure that U.S. implementation efforts are consistent with the Framework; reflect the unique statutory, regulatory and supervisory processes in the United States; and appropriately seek and consider comments on individual aspects of the plan from all interested parties.

Among the critical features in the U.S. implementation plan described in the June 26, 2004 Joint Release was an assessment of the implications of the Framework on U.S. regulatory capital requirements through a domestic quantitative impact study (QIS-4) and the solicitation of public comments on necessary revisions to existing capital adequacy regulations through a notice of

proposed rulemaking (NPR). The Joint Release established a mid-year 2005 target date for the publication of the NPR, with full implementation of Basel II-based rules expected to begin in January 2008, consistent with the timeline in the Basel II Framework.

In another Joint Release published January 27, 2005, the agencies explained their current thinking on optional steps U.S. institutions could begin to take immediately if they wished to prepare for adoption of Basel II-based rules at the earliest possible implementation date. This Joint Release reaffirmed the mid-year 2005 plan for publication of the NPR.

As noted above, the Basel Committee established a common implementation date for the adoption of the Basel II Framework. While necessary to facilitate harmonization among national supervisors, the establishment of a definitive implementation date prior to the development of proposed implementing regulations put significant and unique pressures on the U.S. rulemaking process and on U.S. institutions seeking to adopt the Basel II Framework. To meet AIRB and AMA requirements, those institutions will need to develop and employ extensive data systems, management structures, and control devices. Obviously, without the ability to reference fully articulated implementing regulations and standards, it is difficult for institutions to undertake this work. The January 27, 2005 Joint Release discussed how best to address this problem, especially for those banks wishing to begin preparations now in order to adopt Basel II-based rules at the earliest possible implementation date. However, the need for supervisors and institutions to take tangible steps before the issuance of final rules and guidance will continue to present challenges to the Basel II implementation process.

While the vast majority of the substantive requirements relating to the Basel II Framework were set forth in June 2004, the Basel Committee is still considering additional substantive additions to Basel II. On April 11, 2005, the Basel Committee published for comment a proposal to modify certain aspects of the Basel II Framework. These modifications relate to the treatment of counterparty credit risk for over-the-counter derivatives and certain short-term financing transactions; the treatment of "double-default" effects for hedged transactions; short-term maturity adjustments under internal ratings-based approaches; the valuation, risk management and capital treatment for less liquid instruments held in the trading book; and the design of a

specific capital treatment for unsettled and failed transactions. The Basel Committee and the International Organization of Securities Commissions (IOSCO) jointly developed this proposal, which deals in part with issues especially critical to IOSCO's endorsement of Basel II for securities firms.

The Basel Committee is also considering whether adjustments or clarifications are necessary to the provisions currently in the Basel II Framework regarding how institutions are to take economic downturn conditions into account in developing estimates of loss severities, referred to as loss given default (LGD). Basel II requires banks to consider the extent to which loss severities are likely to exceed long-run average rates during periods when credit default rates are substantially higher than average. When significant cyclical variability in loss severities exists, banks are required to incorporate that variability into their LGD estimates, resulting in so-called "economic downturn" or "stress" LGDs. However, there are currently no established industry standards or common practices relating to how to estimate downturn LGDs, and variances in practice will lead to corresponding differences in capital requirements.

Competitive Effect Concerns

As a critical feature of the Basel II negotiation and implementation process, the OCC and the other agencies have focused considerable effort and attention on the potential competitive effects of the Basel II Framework on the U.S. financial services industry. As the OCC has stated in prior testimony, we are concerned that Basel II may create or exacerbate relative advantages between large domestic banks and mid-size/small domestic banks; between bank and non-banks; and between domestic banks and foreign banks. It is imperative that the U.S. agencies remain sensitive to these concerns and continue to assess any unintended consequences resulting from the implementation of Basel II.

As implemented in the U.S., Basel II would result in a bifurcated regulatory capital regime, with the largest banks subject to Basel II-based requirements and most small and mid-sized banks subject to the current capital regime. This structure is premised on the belief that, to the extent possible, regulations should reflect the size, structure, complexity, and risk profile of banking

institutions. The Basel II Framework was developed to address the unique risks of large internationally active institutions. Mandatory application of such a framework to small banks, with its associated costs, was deemed inappropriate. Rather, the agencies are undertaking a separate but related effort to update and revise existing risk-based capital rules for those institutions not subject to Basel II-based rules. The agencies are developing these two regulatory capital regimes in tandem, to ensure that consideration of competitive effects are factored appropriately into each proposal. A more in-depth discussion of the effort to revise existing risk-based capital rules for those institutions not subject to Basel II-based rules is provided below.

Numerous efforts are in progress to further clarify potential competitive effects of the Basel II Framework on the U.S. financial services industry. Most certainly, the QIS-4 effort is the most direct and in-depth effort to better quantify these effects. The results are germane to both of the rulemaking efforts discussed above. Also, the OCC is preparing a regulatory impact analysis of the Basel II-based regulations pursuant to Executive Order 12866. This assessment of costs, benefits and alternatives will again aid in the assessment of relative competitive effects in our planned regulatory capital proposals. Finally, the agencies have made special efforts to better understand the impact of the Basel II operational risk proposal. Specifically, the agencies have completed on-site reviews of the operational risk practices at the largest U.S. banks and have received and continue to analyze data detailing recent operational risk losses. These efforts will help inform the agencies' work in assessing the extent to which the Basel II Framework might alter competition between certain banks and non-banks, particularly in businesses such as asset management and payments processing.

Each of the above efforts to better understand the potential competitive effects of the Basel II Framework are described in more detail below.

Current Status

Over the past several months, the U.S. agencies have engaged in what may be the most difficult stage of the Basel II implementation process – developing regulations and policies that both foster international harmonization of bank requirements and address the realities and

practicalities of bank practices and bank supervision. As the discussions above and prior agency testimony point out, there is one constant in the OCC's work in this endeavor – reforms to our regulatory and supervisory structure must be adopted in a prudent, reflective manner, consistent with the safety and soundness and continued competitive strength of the U.S. banking system. In this regard, we are fully committed to three things in our on-going analysis of the Basel II Framework: first, an open rule making process in which comments are invited and considered, good suggestions are heeded, and legitimate concerns are addressed; second, a reliable quantitative analysis in which we can assess the likely impact of Basel II on individual banks and on the national banking system *prior* to its adoption; and third, a prudent implementation in which we make well reasoned and well understood changes to bank capital requirements and incorporate in those changes appropriate conservatism.

The U.S. agencies' efforts to better understand the possible effect of Basel II through the QIS-4 process is a critical element of the NPR development process. The QIS-4 process was designed to provide the agencies with a better understanding of how the implementation of the Basel II Framework might affect minimum required risk-based capital within the U.S. banking industry overall, at consolidated U.S. institutions, and for specific portfolios. As mentioned earlier, the Basel Committee has conducted earlier quantitative impact studies, but following the Basel Committee's QIS-3 exercise, it became clear to the U.S. agencies that we needed to do more. The QIS-3 results were simply not reliable in numerous respects – important elements of the proposed Framework were still unsettled, institutions had very little idea of what was expected of them and little ability to generate reliable data with existing systems, and supervisors had only limited ability to tailor the QIS-3 survey to reflect expectations about national implementation decisions. These shortcomings, combined with our steadfast belief in the need to understand the ramifications of Basel II *before* implementation, led us to undertake QIS-4 in the U.S.

While based on the provisions of the international Basel II document, QIS-4 reflected certain adjustments and clarifications needed to tailor the exercise for U.S. implementation and to elicit specific policy information considered helpful for the U.S. rulemaking process. The agencies intend to use the results of the QIS-4 process as critical inputs in the formulation of the NPR and in the assessment of competitive implications of the adoption of the Basel II Framework. QIS-4

results will also inform our efforts to update the U.S. regulatory capital regime for the vast majority of U.S. institutions that are unlikely to either be required to or to opt to use the Basel II-based regulation.

Institutions participating in QIS-4 were asked to submit results in the form of spreadsheets and answers to detailed questionnaires by the end of January. Agency staffs spent most of February and March compiling and assessing those results on an institution-by-institution basis, including direct follow up with institutions when necessary that, in some cases, resulted in substantial resubmissions. I commend the willingness of the industry to participate in this difficult and time-consuming effort.

After completing a preliminary analysis of the QIS-4 spreadsheets and questionnaires, certain initial observations became evident. Although apparently to a lesser extent than with QIS-3, institutions are still at various stages of development of the AIRB and AMA systems and processes necessary to implement the Basel II Framework in the U.S., particularly as it relates to data sufficiency. This differentiation among the industry was somewhat anticipated, but the data challenges are proving to be difficult to resolve, and they created limitations for the QIS-4 process. Even with those limitations, however, QIS-4 represents the best information available to the agencies in our assessment of effects and competitive implications of the implementation of Basel II.

The QIS-4 submissions evidence both a material reduction in the aggregate minimum required capital for the QIS-4 participant population and a significant dispersion of results across institutions and portfolio types. Even acknowledging the differentiation in Basel II readiness among industry participants and the inherent limitations of the QIS-4 process, these results, and the inevitable questions they raise about the underlying causes, are a source of concern for the banking agencies.

Accordingly, on April 29, 2005, the U.S. agencies announced we would not publish an NPR with respect to U.S. implementation of Basel II on the schedule that we had previously announced. In order to ensure that we meet the standards we have set for ourselves in this process – that

reforms to our regulatory and supervisory structure be adopted in a prudent, reflective manner, consistent with the safety and soundness and continued competitive strength of the U.S. banking system – the agencies have concluded that we must undertake additional analysis beyond that contemplated in the initial implementation timeline before publication of an NPR. This additional work is necessary to determine whether the preliminary QIS-4 results reflect actual differences in risk, simply reveal limitations of QIS-4, identify variations in the stages of bank implementation efforts, and/or suggest the need for adjustments to the Basel II Framework.

The decision to delay the NPR was not one that any of us reached easily or took lightly. We are particularly cognizant of the investment that institutions are making to prepare for Basel II implementation and the need those institutions have for greater certainty in the details of the U.S. implementing rules. We also understand U.S. institutions' concerns about maintaining competitive equality with large foreign banks moving perhaps more quickly toward Basel II. Based on the preliminary assessment of QIS-4 results, however, we concluded that a delay was the only responsible course of action available to us.

One measure produced by QIS-4 is the estimated change in "effective minimum required capital," which represents the change in capital components, excluding reserves, required to meet the 8 percent *minimum* total risk-based ratio. This measure is independent of the level of capital actually held by institutions and of their currently measured capital ratios. Aggregating over the QIS-4 participants, the decrease in effective minimum required capital was 17 percent, while the median decrease among participants was 26 percent (see Attachment 1).

Moreover, the dispersion in results – both across institutions and across portfolios – was much wider than we anticipated or than we can readily explain. Changes in effective minimum required capital for individual institutions ranged from a decrease of 47 percent to an increase of 56 percent. For individual QIS-4 participants, these changes would have a direct and dramatic effect on total risk based-capital ratios if existing levels of Tier 1 and total capital held were maintained. They are also roughly indicative of the proportions by which existing levels of risk-based capital would need be reduced or increased in order to maintain an institution's current risk-based capital ratio. While some dispersion of results in a truly more risk-sensitive

framework would be expected, we are not convinced that the wide ranges indicated by QIS-4 can be fully explained by relative differences in risk among institutions; it appears that comparability of QIS-4 results among different institutions may be severely lacking.

Finally, changes in minimum capital requirements – both increases and decreases – of certain portfolios significantly exceeded our expectations (see Attachment 2). An area likely to be of particular interest to a number of U.S. institutions is "qualified retail exposures," or QREs – essentially credit card receivables. For example, the increased capital requirements for QREs raise questions about whether the Basel II Framework runs the risk of disrupting established business models for QRE lenders and potentially affecting pricing or availability of consumer credit. Certain other product lines indicated larger declines in required capital than may be warranted. Residential mortgage and mortgage-related products, such as home equity lines of credit, for example, are among those that will require further analysis to better understand and assess the QIS-4 results and to determine if these results accurately reflect risk.

To the extent that the issues noted above cannot ultimately be explained by actual differences in risk, they may be attributed to either misspecifications in the institution-supplied inputs to the Basel II formulas, or to misspecifications in the formulas themselves. If estimates of basic inputs in the Basel II formulas (i.e., probabilities of default, loss severities in the event of default, and estimates of total exposures at the time of default expected loss) vary significantly between different institutions for similar exposures, that might indicate the possibility of insufficient reliability of the systems of one or both institutions. On the other hand, if inputs are reliably accurate but the resulting capital requirements do not appropriately relate to differences in risk between different exposure types, that would be a sign that the Basel formulas themselves need to be adjusted. Much of the further work we describe below will be designed to help us distinguish between these two types of potential shortcomings.

Next steps

The obvious question this raises is "what now"? We continue to believe in the potential of Basel II to achieve its crucial objectives – improved risk management, supported by significantly

greater risk sensitivity in the regulatory capital framework. Yet, both the supervisory community and the industry have consistently underestimated the time required to convert the conceptual underpinnings of Basel II into a workable regulatory capital regime. We remain committed to pursuing the avenues available to us to find the right balance between flexibility and consistency in implementation of Basel II.

As I have indicated, the issues surfaced during our preliminary work point to a need for additional follow-up. We will continue to work with the other agencies toward a more complete assessment of the QIS-4 results. This assessment will focus on understanding the drivers of the dispersion in capital requirements across institutions as well as the dispersion of capital requirements within particular portfolios. We will also examine the causes of significant increases in capital requirements for credit card receivables and significant decreases for mortgages and mortgage-related products.

The first step in that process will be to continue our review and analysis of quantitative and qualitative information collected as part of the QIS-4 exercise. This information should give us a better sense of whether differences in historical data sets or quantification methodologies used by QIS-4 participants, rather than actual differences in risk, can explain some of the variations in Basel II capital requirements. For example, we are aware from QIS-4 questionnaires and preliminary follow-up discussions that many institutions used relatively short data histories, which, for most retail portfolios, represent a benign economic environment. We will examine whether those institutions using relatively longer data histories that incorporate periods of economic stress generally show higher capital requirements.

We will also conduct additional follow-up with certain QIS-4 participants. This follow-up will include the collection of additional targeted information that will allow us to better assess whether institutions assign significantly different risk parameters to the same or similar loans. For selected credit exposures with similar credit risk characteristics, for example, we expect to be able to compare the inputs that different institutions used in the QIS-4 process. For loans by different institutions to the same borrowers, we will specifically compare probabilities of default, and for some syndicated loans we will also be able to compare loss severities and exposures at

default assigned by different institutions. We expect to make similar comparisons for pools of retail credits with similar risk characteristics.

We will also examine the extent to which different portfolio mixes affected QIS-4 results. For example, we will attempt to quantify the extent to which some institutions' drop in capital requirements are larger than others due to a relatively larger share of low-risk exposures, rather than due to differences in estimation of risk parameters. We will also attempt to examine the effect of the current stage of the economic environment by comparing selected data with data from lower points in the economic cycles. These and other sensitivity analyses should give us a better sense of the factors driving the QIS-4 results.

Once we have completed those steps, the agencies expect to be in a position to fully evaluate additional implications of the QIS-4 results, such as reconsideration of whether and the extent to which adjustments to the formulas or design of Basel II itself may to be needed. If we believe that changes in the Basel II framework are necessary, we will seek to have those changes made by the Basel Committee. While some might argue that the Committee is too far down the path of "finalizing" Basel II to accept any changes at this stage, I do not believe that most Basel Committee members would find their interests best served if the U.S. agencies were compelled to deviate significantly from Basel II in order to fulfill our supervisory responsibilities.

Executive Order 12866

Based on an assessment of its potential effects, the OCC has determined that the rules implementing Basel II will be a "significant regulatory action" for purposes of Executive Order 12866 (EO 12866). Consequently, the OCC (and OTS) must assess all costs and benefits of regulatory alternatives, including the alternative of not regulating. This assessment requires the preparation of a regulatory impact analysis (RIA) that will be published with the NPR.

Prior to publication, we will submit both the NPR and the RIA to the Office of Management and Budget (OMB) for review. The RIA will contain (1) a statement of the need for the proposed action, (2) an examination of alternative approaches, and (3) an evaluation of benefits and costs.

This analysis has begun and will continue, drawing in part on what we learn from additional work on the QIS-4 data. As we understand it, a similar pre-publication submission to OMB will be necessary prior to the issuance of any final Basel II-based rulemaking.

The RIA will describe the statutory authority for the regulatory action and identify the conditions that necessitate the regulatory action. It will include a description of the regulated community and a brief review of the history of capital adequacy regulation. We will analyze several alternatives to the regulatory action we propose, including maintaining the *status quo*, and several alternatives regarding the scope of the application of the proposed rule.

Our analysis of the costs and benefits of the proposal will consider the costs of complying with the proposed rule, the costs to the government of administering the rule, and systemic costs. We will consider the benefits of various features of the proposed rule, including the incorporation of advances in risk measurement and risk management practices into supervisory assessments of capital adequacy, the lessening of distortions in credit markets created by the current capital standard, and improvements in bank safety and soundness from a more risk-sensitive approach to establishing minimum capital requirements. Our analysis will also review the growing body of economic research on the potential for rules that implement the Basel II framework to affect competition among providers of financial services.

Revisions to Capital Rules for Non-Basel II Banks

As the agencies have announced previously, we will continue work on the development of a proposal to update and revise existing risk-based capital rules for those institutions not subject to the Basel II-based regulation in tandem with our ongoing work on Basel II implementation. Among the primary objectives in this effort will be to improve risk sensitivity in the domestic capital regime without the level of complexity found in Basel II. While we know we will not achieve identical results as the Basel II framework, we do expect to reduce some of the more significant differences in capital requirements between Basel II and non-Basel II institutions, and thus reduce potential competitive inequities.

We expect to publish an advance notice of proposed rulemaking concurrently with the Basel II NPR that will further explore and seek comment on possible revisions to the regulatory capital rules that will continue to be applicable to those banks not subject to Basel II. Because this proposal is a work in process, I can only speak about it in general terms, but some of the broad types of revisions that we are considering include: increasing the number of risk weight categories; expanding the use of external ratings in determining risk weights; modifying the risk weights associated with residential mortgages; assigning a credit conversion factor to certain types of short-term commitments and to certain securitization transactions; and assigning potentially higher risk weights to past due, nonaccrual and other loans deemed to present higher than normal risk.

Operational Risk

One of the most contentious issues in the development of the Basel II Framework was the introduction of operational risk as a separate and distinct component of minimum regulatory capital. Since the inception of the Basel II proposal, there were two competing views of the regulatory treatment of operational risk. Some have argued that operational risk is sufficiently similar to credit risk and market risk to be included as a Pillar 1 charge directly in capital regulations. Others have maintained that operational risk inheres in the quality of an institution's internal control systems, supporting a Pillar 2 approach in which supervisors focus on the qualitative evaluations of such systems.

It is important here to explain the evolution of the Basel Committee's consideration of operational risk, especially the development of the AMA proposal. While still included within Pillar 1, the AMA evidences a clear movement towards the principles underlying Pillar 2. Under the AMA, institutions will use their own internal assessment of the operational risks they face and the capital needed to support those risks, subject to supervisory approval. As set forth in the Basel II Framework, institutions would have considerable flexibility in developing their AMA estimates, provided their processes are comprehensive and well reasoned, and reflect accurately the risks the institution faces.

While recognizing the evolving nature of operational risk management as a discipline and the difficulties in quantifying operational risk exposures, institutions are making progress in developing and implementing effective operational risk management and measurement techniques. Over the past year, the U.S. agencies have undertaken a number of projects to directly assess the industry's efforts in this regard. During 2004, the agencies conducted an operational risk benchmarking review at each U.S. bank subject to Basel II-based rules on a mandatory basis as proposed under the ANPR. These reviews were intended to identify the current range of practice within the industry for the measurement and management of operational risk, to help assess the appropriateness of the agencies' current AMA guidance, and to assist agency efforts to develop additional supervisory guidance and training materials for institutions and examiners. Additionally, in conjunction with the QIS-4 process described earlier, the U.S. agencies also commenced an operational risk loss data collection exercise (LDCE). The LDCE was a voluntary survey that asked banking organizations to report the amount of individual operational losses as well as certain descriptive information regarding each loss (e.g., date, business line, loss type). The primary purpose of the LDCE was to aid supervisors in better understanding the completeness of the internal loss data on which the QIS-4 results are based and the extent to which those results depend on an institution's internal data, choice of modeling approaches, the incorporation of qualitative risk assessments, or other factors.

Preliminary analysis of the benchmarking and LDCE results highlights the significant efforts banks are making in addressing AMA requirements. The analysis of LDCE results confirms progress in the creation of AMA governance structures, development of quantification models, and construction of data systems to capture operational risk loss events. However, that analysis also confirms the need for additional work. Significant challenges remain in the collection and maintenance of comprehensive loss data and in model validation necessary to the development of acceptable AMA methodologies.

H.R. 1226

Recently introduced legislation entitled "The United States Financial Policy Committee for Fair Capital Standards Act" (H.R. 1226) would create an interagency Financial Policy Committee (FPC), chaired by the Secretary of the Treasury, responsible for unifying U.S. positions and reporting to Congress on the impact that Basel II would have on domestic and global financial systems. The FPC is designed to develop a cohesive U.S. government position prior to negotiating with other regulators on the Basel Committee. In the event of disagreement among the regulators or an inability to reach a consensus, the position of the Secretary of the Treasury would prevail.

We understand and share the desire of the bill's sponsors to make sure that the banking agencies adopt a uniform approach and that the impact of Basel II is well understood before it is adopted. As principal participants in both the Basel II and the domestic rulemaking processes, however, we do not believe that legislation is needed to compel that result. The rulemaking process itself for Basel II is an interagency endeavor that involves all the banking agencies in joint rulemaking. While we have not all agreed on every issue at every stage of the process, the interagency approach by necessity is highly collaborative and we are confident that we will continue to be able to work out any future differences, just as we commonly do in other joint rulemaking exercises. The fact that we recently agreed to delay the publication of the NPR is indicative of our commitment and ability to work together to ensure a full understanding of the ramifications of Basel II before proceeding with the next step in that formal rulemaking process.

Additional safeguards are already in place to require us to fully understand and publicly report on the implications of Basel II implementation in the U.S. Specifically, as noted above, the OCC has determined that the NPR regarding Basel II implementation will be a "significant regulatory action" for purposes of EO 12866. EO 12866 requires the OCC (and OTS) to provide specific information to the OMB for review prior to publication of the NPR and any final rule, including an assessment of the costs and benefits of the proposed regulatory action. We have begun this

assessment, which will incorporate the results of additional QIS-4 analyses and will be published when the NPR is issued.

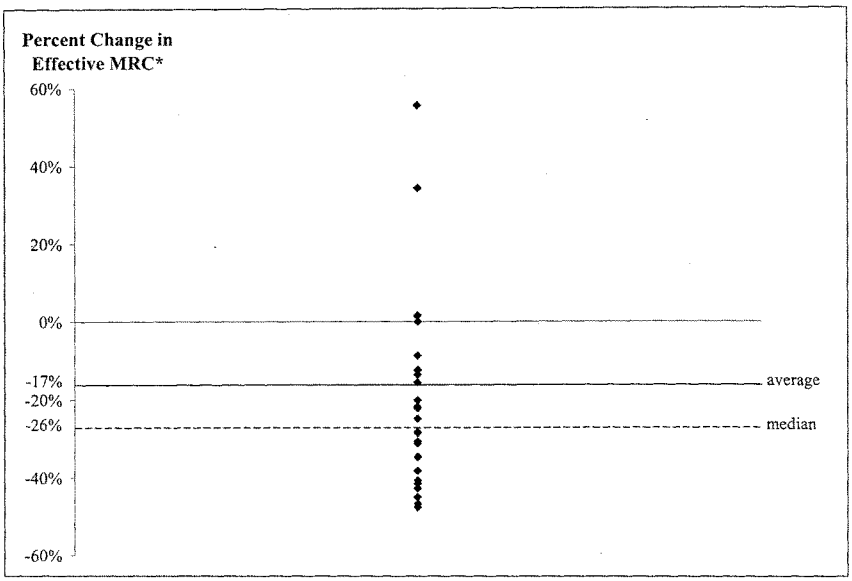
In short, we believe the interagency process is working well as currently structured and we are already obligated to conduct and make publicly available the kinds of analyses envisioned by H.R. 1226.

Conclusion

QIS-4 identified issues that we need to understand before taking the next formal steps toward U.S. implementation of Basel II – i.e., issuing an NPR. We cannot yet answer all the questions raised by those issues, but we remain committed to proceeding in a responsible manner. Despite the significant challenges that remain, we are committed to developing a revised risk-based framework that is fully consistent with safety and soundness, good risk management practices, and the continued competitive strength of all sectors of the U.S. banking system.

Attachment 1

Preliminary Change in Effective Minimum Capital Requirements of Participating Institutions: Basel I to Basel II



*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is preliminary data as of May 5, 2005 for the twenty-six participating QIS-4 institutions; caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies plan additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.

Attachment 2

Preliminary Change in Minimum Capital Requirements of Participating Institutions: Basel I to Basel II

Portfolio	% Change in Portfolio MRC	Median % Change in Port. MRC	Share of Basel I MRC	Share of Basel II MRC
Wholesale Credit	**(25%)**	**(24%)**	**44.3%**	**38.8%**
Corporate, Bank, Sovereign	(22%)	(30%)	33.9%	30.7%
Small Business	(26%)	(27%)	4.6%	4.0%
High Volatility CRE	(33%)	(23%)	1.8%	1.4%
Incoming Producing RE	(41%)	(52%)	4.0%	2.7%
Retail Credit	**(26%)**	**(50%)**	**30.5%**	**26.3%**
Home Equity (HELOC)	(74%)	(79%)	6.1%	1.8%
Residential Mortgage	(62%)	(73%)	11.1%	4.9%
Credit Card (QRE)	66%	63%	6.1%	11.7%
Other Consumer	(7%)	(35%)	6.0%	6.5%
Retail Business Exposures	(6%)	(29%)	1.2%	1.3%
Equity	11%	(9%)	1.3%	1.6%
Other assets	(12%)	(3%)	10.1%	10.4%
Securitization	(20%)	(40%)	7.9%	7.7%
Operational Risk			**0.0%**	**9.0%**
Trading Book	0%	0%	5.2%	6.0%
Portfolio Total	**(14%)**	**(24%)**	**100.0%**	**100.0%**
Change in Effective MRC*	**(17%)**	**(26%)**		

*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is preliminary data as of May 5, 2005 for the twenty-six participating QIS-4 institutions; caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies plan additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.

Basel II:
Capital Changes in the U.S. Banking System and the Results of the Impact Study

Joint Hearing Before the
Subcommittee on Financial Institutions and Consumer Credit
and the
Subcommittee on Domestic and International Monetary Policy, Trade, and Technology

Additional Questions and Answers for the Hearing Record

1. The argument has been made that regulatory capital arbitrage is not necessarily a bad thing when it moves risk out of the banking system. Please comment on this view. Should the Committee be concerned that the competitive disparities created by the operational risk-based capital charge could lead to the movement of assets outside the banking system?

2. Some maintain that U.S. investment banks are under a regime comparable to the Basel II framework, which has been imposed on them by the SEC. Is this characterization of the SEC regime correct? Are there any aspects of the SEC's standards that should raise concern? Does the SEC regime solve the bank/nonbank competitiveness problem?

3. Can you explain what a "low hanging fruit" approach to Basel II implementation would entail? Is this a viable approach to implementing the Accord in the U.S.?

4. Would an operational risk-based capital charge like the one now proposed have done anything to prevent recent losses due to operational risk, such as the Barings case, where a rogue trader brought down the entire bank, and even the Citigroup legal risk reserves in the wake of Enron, WorldCom and other problems. Have any banks besides Barings ever failed because of operational risk?

5. Interest-rate risk was a significant – if not the main – contributor to the collapse of the U.S. savings and loan industry, costing taxpayers about $200 billion. How is interest-rate risk treated under Basel II?

6. Is there a link between the legal risk component of the operational risk-based capital charge and U.S./EU competitiveness? Treatment of this risk is of particular concern to the U.S. because of laws intended to further important U.S. social policy objectives. How should the regulators implement the Accord without penalizing U.S. banks for this country's focus on these important social policy initiatives?

7. Many commentators have expressed concerns regarding the creation of an "unlevel playing field" due to high levels of national discretion contained in the new Basel Capital Accord. Is there a serious likelihood that Basel will not be applied uniformly around the world?

8. What is your position on H.R. 1226?

9. The Federal Reserve Board has done a preliminary study on the effect of Basel II on mergers and acquisitions activity within the banking industry as well as one on the impact of the operational risk-based capital charge. Please comment on these two studies.

September 6, 2005

Susan Schmidt Bies
Governor
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

John M. Reich
Director
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

John C. Dugan
Comptroller
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Donald E. Powell
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Dear Governor Bies, Director Reich, Comptroller Dugan and Chairman Powell,

Based on recent discussions between state and federal banking regulators as well as media reports and Congressional testimony on the findings in the fourth Quantitative Impact Study (QIS-4) for the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," commonly known as Basel II, the Conference of State Bank Supervisors (CSBS)[1] understands that the federal banking agencies plan to meet with our international banking regulatory counterparts in October 2005 and plan to indicate the U.S. intent on finalizing the Basel II framework. CSBS requests that the federal regulators *not* hastily commit to the international Basel II regulators regarding the U.S. implementation of the significant changes contained in the proposed Basel II rules.

When the Basel II discussions began nearly eight years ago, the intent was not to substantially reduce capital requirements for larger institutions from their current levels. Indeed, there has been no public consideration to date of the proposition that U.S. bank capital regulations are unduly conservative and need to be relaxed. The framework was envisioned to increase the capital required for riskier activities and reduce the capital required for the less risky activities. The initial discussions assumed that a Basel II proposal would basically be capital-neutral, or perhaps allow for a modest reduction in regulatory capital to induce banks to adopt the new approach. CSBS agrees with this initial concept.

[1] CSBS is the national organization of state officials responsible for chartering, regulating and supervising the nation's 6,240 state chartered commercial and savings banks and 400 state-licensed branches and agencies of foreign banks.

CONFERENCE OF STATE BANK SUPERVISORS
1155 Connecticut Ave., NW, 5th Floor · Washington, DC 20036-4306 · (202) 296-2840 · FAX (202) 296-1928

CSBS supports a more risk-sensitive capital framework for financial institutions. In this regard, we believe the general conceptual foundation of Basel II is appropriate. CSBS, however, understands that QIS-4 indicates that the average reductions in capital requirements based on the implementing rule for Basel II could be substantial. Capital requirements for specific business lines could change even more dramatically with QIS-4 outcomes, ranging from an increase of 50 percent to a decrease reaching 90 percent.

The QIS-4 results are of deep concern to state banking supervisors for several reasons. Although a limited number of institutions are expected to participate in the Basel II capital regime, we believe the capital reductions allowed under this proposal could place community and mid-tier, regional banks at a real competitive disadvantage. The current Basel II proposal seems to provide incentives that could hasten consolidation within the banking arena and threaten to further bifurcate the industry. In addition, minimal capital requirements at these large, complex financial institutions create systemic safety and soundness concerns.

Potential Implications

Implementing the risk-based capital requirements depicted in the recent studies could have profound competitive implications and significantly harm the banking industry in general and non-Basel II banks in particular. As proposed, Basel II creates significant differences between capital requirements of banks that adopt Basel II and those that do not. The current approach reduces the capital large institutions hold for mortgages and small business loans, among other assets. In a very practical sense, the reduced capital requirements would provide a pricing advantage for the larger institutions. It will be difficult for smaller banks to compete for mortgages and small business loans and certainly difficult for these institutions to hold such assets in their portfolio. In a competitive economy, eventually market forces will likely drive these assets from smaller banks toward the Basel II adopting banks, requiring non-adopting banks, the vast majority of which are small community banks, to move to higher-risk areas of banking.

In addition, with substantially lower capital requirements, larger institutions could acquire community and mid-tier banks without much cost involved by immediately lowering the acquired bank's required capital to a level that is allowed by Basel II banks. The lower capital requirements and the magic of the current Basel II mathematics promote the incentive for consolidation within the banking industry.

Under the current Basel II proposal, the quantitative amount of risk-based capital necessary to be considered well capitalized may be significantly reduced for diversified, large banks, thereby reducing the cushion when things go wrong. Mathematical formulas work in theory, but CSBS has reservations about how well these models can account for unexpected occurrences, such as a default by a large country, a sudden drop in housing prices, a dramatic change in the price of oil, or a meltdown of the derivatives market. The lower capital requirements could arguably also result in a substantial undermining of the prompt corrective action system enacted by Congress in 1991.

CSBS is concerned that allowing our country's very largest financial institutions to maintain capital at QIS-4 levels promotes the theory of "too big to fail," creates moral hazard issues, and poses a serious threat to the federal deposit insurance fund. We believe such an outcome would diminish bank management's accountability for risk management and allow an entity to take risks it would not otherwise. As we have seen on countless occasions in the past, these additional risks can be felt much more deeply at the local level than their overall effect on the national economy in general. Smaller communities can be devastated when their source of funds is restrained or completely disappears.

There may be ways of addressing the concerns described above by changing Basel II in a way that moderates its tendency to produce what we believe are unsafe and unsound capital levels. We ask that the federal agencies slow the Basel II process, take the time needed to find sound solutions, and not rush to implement a capital system that could produce undesirable impacts not only on capital and competition, but also on our citizens and the national economy as a whole.

Outstanding Issues

Prior to committing to our international regulatory counterparts on implementing Basel II in its current form, CSBS believes the following issues must be addressed and answered.

- What are the real life effects of Basel II? Prior to implementing final rules, the agencies should take into account not only the amount of capital institutions will be required to maintain but also the potential impact to the deposit insurance funds, the impact on product distribution between large and small banks, and the likely outcome for local communities.
- Should the leverage ratio be maintained for all institutions and, if so, what is the appropriate level? If the leverage ratio is maintained, will the cost of implementing Basel II be justified?
- How might small and community banks be affected by implementing Basel II? And, if they are put at a competitive disadvantage as CSBS believes, how do the agencies plan to change the current domestic capital rules, without increasing burden on those smaller institutions?
- Should the federal agencies extend the floor currently proposed for only the first two years? (The floor provides that a bank cannot reduce its capital by more than 80% under Basel II, even if the formula indicates a lower capital level.)
- Should regulators consider an alternative approach that is not based on complex mathematical formulas, but instead gives more discretion to the regulators to adjust capital based on the risk of the institution?

We strongly urge the federal banking agencies to obtain a much better sense of the real-life ramifications of executing Basel II prior to giving any indication to our foreign counterparts about implementation. Additionally, any potential changes to the capital requirements should be rolled out to *all* institutions simultaneously so as not to inadvertently provide pricing advantages to any particular set of institutions.

Conclusion

The results from QIS-4 do not appear to adhere to the initial expectations of Basel II and cause great concern at the state level. CSBS is not convinced that Basel II as currently proposed is consistent with the responsibilities of banking regulatory agencies to prescribe by regulation an adequate level of capital. It also does not appear to be consistent with regulators' traditional function of promoting a level playing field.

Basel II makes a large bet with the future of the U.S. financial system. Accordingly, CSBS strongly urges the federal banking agencies to conduct further analysis of potential capital changes that would ensue from adopting the current Basel II proposal, reflect on agencies' initial expectations about potential capital changes, and take a measured and deliberate approach going forward.

Thank you for your consideration of these concerns. As always, CSBS and the state banking departments stand ready to provide any further supervisory information related to capital requirements as you desire.

Best personal regards,

Neil Milner, CAE
President and CEO

MICHAEL G. OXLEY, OH, CHAIRMAN

JAMES A. LEACH, IA
RICHARD H. BAKER, LA
DEBORAH PRYCE, OH
SPENCER BACHUS, AL
MICHAEL N. CASTLE, DE
PETER T. KING, NY
EDWARD R. ROYCE, CA
FRANK D. LUCAS, OK
ROBERT W. NEY, OH
SUE W. KELLY, NY
Vice Chairs
RON PAUL, TX
PAUL E. GILLMOR, OH
JIM RYUN, KS
STEVEN C. LaTOURETTE, OH
DONALD A. MANZULLO, IL
WALTER B. JONES, JR., NC
JUDY BIGGERT, IL
CHRISTOPHER SHAYS, CT

VITO FOSSELLA, NY
GARY G. MILLER, CA
PATRICK J. TIBERI, OH
MARK R. KENNEDY, MN
TOM FEENEY, FL
JEB HENSARLING, TX
SCOTT GARRETT, NJ
GINNY BROWN-WAITE, FL
J. GRESHAM BARRETT, SC
KATHERINE HARRIS, FL
RICK RENZI, AZ
JIM GERLACH, PA
STEVAN PEARCE, NM
RANDY NEUGEBAUER, TX
TOM PRICE, GA
MICHAEL G. FITZPATRICK, PA
GEOFF DAVIS, KY
PATRICK T. McHENRY, NC

ROBERT U. FOSTER III
STAFF DIRECTOR

U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

BARNEY FRANK, MA, RANKING MEMBER

PAUL E. KANJORSKI, PA
MAXINE WATERS, CA
CAROLYN B. MALONEY, NY
LUIS V. GUTIERREZ, IL
NYDIA M. VELÁZQUEZ, NY
MELVIN L. WATT, NC
GARY L. ACKERMAN, NY
DARLENE HOOLEY, OR
JULIA CARSON, IN
BRAD SHERMAN, CA
GREGORY W. MEEKS, NY
BARBARA LEE, CA
DENNIS MOORE, KS
MICHAEL E. CAPUANO, MA
HAROLD E. FORD, JR., TN
RUBÉN HINOJOSA, TX
JOSEPH CROWLEY, NY

WM LACY CLAY, MO
STEVE ISRAEL, NY
CAROLYN McCARTHY, NY
JOE BACA, CA
JIM MATHESON, UT
STEPHEN F. LYNCH, MA
BRAD MILLER, NC
DAVID SCOTT, GA
ARTUR DAVIS, AL
AL GREEN, TX
EMANUEL CLEAVER, MO
MELISSA L. BEAN, IL
DEBBIE WASSERMAN SCHULTZ, FL
GWEN MOORE, WI

BERNARD SANDERS, VT

September 13, 2005

The Honorable Alan Greenspan
Chairman
Board of Governors of the Federal Reserve System
20th and Constitution Streets, N.W.
Washington, D.C. 20551

Dear Chairman Greenspan:

We were disturbed by the attached American Banker article suggesting that Federal Reserve Board staff are actively discouraging Federal Reserve Bank staff from expressing independent views on the Basel II Capital Accord.

This is a very important issue as you know and it is necessary for Congress to be fully informed. Clearly, it is inappropriate for there to be any effort to interfere with the information Congress receives. If this article is accurate, we ask that you please take the necessary steps to ensure that no Federal Reserve official interferes with Congress's access to information.

Yours truly,

BARNEY FRANK
Ranking Member

MICHAEL G. OXLEY
Chairman

CAROLYN B. MALONEY
Ranking Member
Subcommittee on Domestic and
International Monetary Policy,
Trade, and Technology

SPENCER BACHUS
Chairman
Subcommittee on Domestic and
International Monetary Policy,
Trade, and Technology

Enclosure

In Focus: Stress Shows At Fed with Basel II Drive Sputtering

American Banker << OLE Object: Picture (Metafile) >> Monday, August 29, 2005
By Damian Paletta

WASHINGTON - The Federal Reserve Board faces a series of daunting challenges to keep Basel II on track, including internal divisions, fights with fellow regulators, and possible congressional interference.

The central bank last week urged its 12 banks to fall in line and communicate a unified message on Basel II as it prepares for a major strategy meeting next month with the other banking and thrift agencies. It also has repeatedly disputed charges it is bullying its fellow supervisors into adopting the plan, and that once implemented it would result in steep drops in capital at banks.

The stakes are high for the Fed, which has taken the lead domestically to complete the capital accord and hopes to have it implemented by 2008. But the agency is facing increasing skepticism it can release the next stage of the plan in order to meet the deadline.

A sign of the mounting pressure came last week when the agency's director of supervision sent a memo to all 12 regional banks the same day a front-page American Banker article said the effort was stalling. Trying to ensure the Fed speaks with one voice on Basel II, Richard Spillenkothen said he would soon issue question-and-answer sheets that Fed officials should use when discussing the capital standard with outsiders.

"During this period of continued negotiation and development around capital reform, it is critical that Board staff and Reserve Bank staff have good communications and coordination of activities," Mr. Spillenkothen wrote.

Observers said the Fed wants to keep strife within the agency from showing.

"There is obviously a high level of concern within the Fed, particularly at the board, about where Basel II is going," said Bert Ely, a banking analyst in Alexandria, Va. "They don't want anybody talking out of school. They want to reinforce that 'We are going to speak with one voice and that voice is going to come from Washington.' "

There has already been some disagreement. In April three economists with the Federal Reserve Bank of St. Louis wrote in Regional Economist, a quarterly magazine the St. Louis Fed publishes, that community banks could face a mortgage pricing disparity because large Basel II banks with lower capital requirements could cut loan prices.

Basel II banks "may be able to offer more competitive lending rates" than other banks, St. Louis Fed President William Poole wrote in an introduction to the article. "Banks not operating under Basel II, then, may have to look for loan opportunities that are not affected as much by the new approach."

The article contradicted a much-anticipated report released in April by four Fed economists, who said Basel II banks would continue to set their mortgage prices by secondary-market requirements, not capital levels. An earlier version of that report, by former Fed economists Paul Calem and James Follain, was not published, but its conclusions also supported the view that Basel II would give large banks an advantage.

Mr. Spillenkothen's memo also asked the Reserve banks to tell the Fed what bankers are saying about Basel II, as well as "other supervisory efforts related to economic capital, risk measurement, or risk management."

"This clearly shows that there is a level of concern at the Reserve banks, but it doesn't mean that the Basel process is going to blow up," said Jaret Seiberg, a policy analyst for the Stanford Washington Research Group.

A Fed spokesman downplayed the memo, saying it "is not unusual for the board to coordinate with the Reserve banks on policy issues, particularly during important stages in their development - such as this one during the implementation of new capital regimes in the United States."

Some industry representatives said the Fed was trying to respond to a growing perception that the Basel II process has gone astray.

"There's a lot of questions going around about who should say what," said Pamela Martin, director of regulatory relations for the Risk Management Association. The Fed "needs to have a coordinated effort to get everybody on the same page. You want your examiners on the same page, especially when there are tons of rumors flying around. ... That's just good management."

The memo also underscored that some Fed officials are personally invested in the Basel II process.

"There is a pride of ownership at the Fed regarding the Basel committee," said David Fanger, the senior vice president of the banking group at Moody's Investors Service Inc.

A major impact study released in April handed critics - including other regulators - evidence that Basel II capital requirements might have flaws. The study, called QIS-4, showed an uneven spike and drop in capital requirements among banks, even at financial institutions with similar risk portfolios. Regulators had repeatedly promised capital levels would remain flat.

Federal Deposit Insurance Corp. Chairman Don Powell used the study as proof the process should slow down, despite the Fed's effort to issue a new proposal by yearend. He has said he does not expect regulators to have ironed out their differences in time. Some lawmakers have publicly said the Fed is rushing the other regulators - a charge the central bank denies.

Though Fed officials have maintained they could still make the deadline, Mr. Spillenkothen signaled in the memo that this was increasingly unlikely.

"We expect that this deliberative process, including the comment periods and requirements for OMB review, will extend well into next year," he wrote in the memo.

If U.S. banks are to implement Basel II by January 2008, all their systems would have to be in place by January 2007, because regulators want to run both the old standards and the new ones simultaneously for testing. That would give banks several months at the most to bring their systems into compliance once a final rule is issued.

Top federal regulators are expected to meet again next month ahead of an Oct. 3 Basel Committee on Banking Supervision summit in Switzerland to attempt to iron out their differences.

The Fed could also see Congress take a more active role. Senate Banking Committee Chairman Richard Shelby criticized the plan last month and said he wants to hold a hearing on the process in September or October.

"I'm not fully confident that the so-called 'right standards' have been proposed," Sen. Shelby said.

House Financial Services Committee Chairman Michael G. Oxley has threatened to pass a bill that would require the Treasury Department to step in if interagency conflicts on Basel II persist.

Basel II Capital Accord:

A Guide for the Perplexed

By

Raymond Natter, Esq.
Barnett Sivon & Natter
Washington, D.C.

September 21, 2005

Basel II Capital Accord
A Guide for the Perplexed

Introduction

The Basel II Capital Accord is facing its moment of truth. The Accord, which is scheduled to be implemented by January of 2008, will affect, directly or indirectly, the entire banking industry, including regional and community banks and savings institutions, and could result in fundamental changes in the number, size and business lines of all types of depository institutions. It could also have a significant impact on the availability and cost of credit for the entire economy. As a result, the Accord has become a subject of controversy among the banking agencies, Congress, the financial services industry and academic experts. This paper provides information on why the Accord was developed, the essential changes that it makes in capital policy, and the arguments for and against the proposal. It also offers some suggestions for implementation of the Accord that will mitigate some of the concerns raised with the current plan.

The Current Basel Capital System

In the early 1980s the world=s banking system was in crisis. Capital levels of major international banks were deteriorating. At the same time, the risks associated with cross-border banking were increasing, and concerns were expressed that the debt load of many of the developing countries was too excessive. In fact, in 1982 Mexico announced that it was unable to repay its foreign debt obligations, and a group of 17 Ahighly indebted countries≅ asked for concessions on their loan terms.

In light of these developments, the central banks and other bank supervisory officials from the leading economic powers met in Basel, Switzerland to formulate a plan to enhance bank capital. The Basel Committee[1] determined that the best way to strengthen capital and to reduce competitive inequalities was to formulate a uniform international capital standard that reflected the riskiness of the institution=s assets, including off-balance sheet assets (such as guarantees and long-term loan commitments). In July 1988, a capital framework was approved by the members of the Committee and implemented by the individual countries represented on the Committee, as well as other countries. This standard is now referred to as Basel I.[2] Under Basel I, a bank=s assets are assigned one of four risk weights or baskets, ranging from 100 percent to 0 percent, and a capital charge is assessed on the risk-adjusted value of the asset. For example, a commercial loan is risk-weighted at 100 percent and a residential mortgage loan is

[1] The Basel Committee was originally formed in 1974 by the Central Banks of the AGroup of Ten≅ - the major industrial countries that are members of the IMF. The Basel Committee consists of Central Bank and banking supervisors from the Group of Ten, plus Spain and Luxembourg.

[2] Since its issuance in 1988 it has been amended on several occasions, for example in 1995 to take into account the beneficial effects of netting provisions, in 1996 to recognize the need to hold capital for market risk, and in 2001 to change the capital treatment of residual interests and direct credit substitutes.

risk-weighted at 50 percent. Thus the minimum capital ratio of 8 percent requires $80 of capital for a $1,000 commercial loan, but only $40 of capital for a $1,000 residential mortgage loan.

Origins of the New Capital Framework

It is widely recognized that the original Capital Accord significantly strengthened the capital levels and safety and soundness of the banking system, and helped provide competitive equality among banks operating internationally.[3] However, by the late 1990s the original Accord was also viewed as a rather crude instrument for setting risk-based capital levels. For example, all commercial loans are placed in the same risk-weighted basket, despite considerable differences in the creditworthiness of the counterparties. Basel I also creates incentives for a bank to securitize its best assets and to hold in portfolio riskier assets within the same risk-weighted basket. Finally, the Basel I framework does not encourage the use of risk mitigation techniques.[4]

In response to these and other perceived weaknesses, the Basel Committee proposed a new capital framework in June 1999.[5] Following a public comment period, and several revisions, this framework evolved into the Basel II Accord that was agreed to on June 26, 2004, and is now being implemented internationally. The main objectives of the new proposal are to make capital requirements more risk sensitive, encourage institutions to improve their risk management techniques, incorporate more fully off-balance sheet risks, and enhance competitive equality among institutions operating internationally.

Basel II Basics

The Basel II Accord envisions a three-pronged approach to enhancing the safety and

---

[3] AA New Capital Adequacy Framework,≅ Consultative paper issued by the Basel Committee on Banking Supervision (June 1999).

[4] Id.; See also: Statement of Roger Ferguson, Member of the Board of Governors of the Federal Reserve System, Before the Senate Banking Committee (June 18, 2003); FDIC Staff Study, ABasel and the Evolution of Capital Regulation: Moving Forward, Looking Back." (January 14, 2003).

[5] Id.

soundness of financial institutions: (i) new capital standards; (ii) enhanced supervision; and (iii) increased market discipline through additional public disclosures.[6] Most of the attention has focused on the first pillar, the new capital standards.

With respect to capital, the Accord permits depository institutions to adopt one of two methods for risk weighting of assets: the Astandardized≅ model or the Ainternal ratings based≅ (IRB) model. In the United States however, only the internal ratings based model will be used.

The standardized model is easier to apply and closer in approach to the existing Basel I framework. Under the standardized approach, risk weights are assigned to assets based on the credit rating the counterparty (or the asset) has received from an independent third party rating agency, such as Standard and Poors. For example, a loan to a corporation that has an S&P credit rating of AAAA≅ would be assigned a risk weight of 20 percent, while a loan to a corporation with an AA≅ rating would be given a risk weight of 50 percent. On the other hand, if the counterparty has a credit rating below ABB-A the risk weighting would be 150 percent. The standardized approach would assign a risk weight of 75 percent to a portfolio of retail loans to individuals or small business. Prudentially underwritten residential mortgage loans are assigned a weight of 35 percent. The standardized approach also provides beneficial capital treatment of loans that are collateralized or protected by enforceable guarantees.

As mentioned, the standardized approach will *not* be used in the United States. Instead, the U.S. bank regulatory agencies will institute the internal ratings based or IRB model. This is a much more complex system that requires banks themselves to determine required capital, based on the criteria and formulas contained in the framework.

Under the Accord, there are two alternative IRB models, Afoundation≅ and Aadvanced,≅ (A-IRB). The foundation model relies heavily on risk data Ainputs≅ provided by the agencies, with limited computations required by the banks. However, in the United States the foundation model is not being proposed, and instead institutions using the Basel II standards will be required to use the advanced model.

Under the advanced internal ratings based (A-IRB) approach each covered bank must determine specified key data or inputs for its wholesale and retail exposures and equity holdings. The data that the bank must compute includes: (i) the probability of default (PD); (ii) the probable loss to the bank if a default occurs (LGD); (iii) the bank=s exposure at default (EAD), for example, the estimated outstanding loan balance at the time of default; and (iv) for certain loans, the maturity of the exposure at default (M). For retail credits, the bank would determine

[6] Basel Committee on Banking Supervision, AInternational Convergence of Capital Measurement and Capital Standards: A Revised Framework,≅ (June 2004).

the required data for pools of loans with similar risk characteristics, rather than on a borrower-by-borrower basis. After the bank determines these inputs, the Accord provides mathematical formulas for determining the amount of capital necessary to cover the bank=s exposure. Other rules would be used to provide a capital requirement for securitized and off-balance sheet assets.

In determining the required inputs, banks are required to meet minimum supervisory standards. While these standards have not been finalized, certain key requirements have been identified. For example, the bank would be expected to have adequate data to support its ratings and to continually monitor and validate the accuracy of these ratings. Bank requirements are expected to include compiling at least a five-year history of data relating to loans and other assets, and possibly longer if a period of stress for a particular class of borrower occurred prior to the five-year period. Some data will be obtained from external sources, while other information will need to be generated from the bank=s own experience.

Operational Risk

In addition to credit risk, the Accord requires covered financial institutions to hold capital to protect against Aoperational risk,≅ which is the risk to an institution presented by its normal operations, e.g. the risk that a natural disaster will disrupt business, that a computer system will fail or malfunction, that a employee will violate a fiduciary duty, or that the bank will be the victim of internal or external fraud. It also includes the risk posed by litigation and failure to comply with regulatory mandates.[7]

The Basel II Accord provides alternative means for computing a capital charge for operational risk. The basic approach simply requires a bank to hold additional capital equal to 15 percent of the bank=s average gross income for the previous three years. The standardized approach divides a bank=s activities into eight business lines, and then establishes a capital charge for each business line equal to a fixed percentage (ranging from 12 to 18 percent) of the average gross income from each line. The advanced measurement approach or AAMA≅ requires each covered bank to establish an operational risk capital charge based on its own calculation of risk. Only the advanced approach will be used in the United States.

In order to use the advanced approach, the financial institution would have to meet regulatory standards relating to the institution=s management and oversight of its operations. The bank must also undertake a comprehensive identification and measurement of its operational risk and compile historical data on operational risk losses, both internal and external. Finally, the institution will be required to determine an amount of capital that would be able to cover potential losses due to operations with a 99.9 percent level of confidence.[8]

---

[7] The 2004 Accord defines Aoperational risk≅ as the Arisk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risk.≅ (2004 Accord, par. 644)

[8] One commentator estimates that U.S. financial institutions would have to hold as much as $67 billion in

Mandatory and Opt-In Banks

The U.S. banking agencies have stated that only two groups of institutions will be subject to Basel II Capital: mandatory or core banks and opt-in banks. The mandatory banks include banks with total banking assets in excess of $250 billion and banks with total foreign exposures in excess of $10 billion. Opt-in banks are those banks that voluntary wish to become subject to Basel II, and have the resources and technical capability to comply with its requirements. It is estimated that approximately ten institutions will be subject to mandatory coverage.

Arguments for Basel II

Supporters of Basel II argue that it more accurately measures the risk of large financial institutions and better captures many of the complex transactions and activities of these institutions. The new system provides capital incentives for depository institutions to hold higher quality credits, and negates the benefits of financial strategies designed to remove high quality assets from a bank=s books in order to obtain capital relief. By more closely aligning regulatory capital with the risk posed by an asset, the cost of credit will more accurately reflect the economic cost to make the loan. Thus, for lower risk loans, such as home mortgages, banks and savings associations will be able to reduce the cost of the loan to the consumer. Basel II also permits financial institution=s to benefit from the latest techniques in risk management and statistical analysis, and encourages financial institutions to utilize state of the art risk management techniques if they are not already doing so. Finally, in light of the fact that the major economic powers worldwide will be implementing Basel II for their internationally active financial institutions, failure to implement the new Accord for our institutions will place them at a significant competitive disadvantage when in the global marketplace.

Concerns With Basel II

Opponents of Basel II argue that the new standard is overly complex and too prescriptive. Opponents note that the required methodology is not necessarily the best approach for all covered banks, and that it does not always comport with the bank=s own internal models. Assessing a capital charge for operational risk is viewed as inappropriate in light of the difficulty in quantifying these risks, and the lack of methodology for obtaining meaningful results. As an alternative, it is recommend that operational risks be dealt with in the supervisory process rather than through a capital charge. Concerns have also been raised that the new system will have the effect of lowering the capital cushion for many institutions thereby undermining prompt

---

additional capital to comply with the operational risk requirement. See, Karen Shaw Petrou, ABasel II Regulation: U.S. Market and Competitiveness Implications,≅ Statement Before the House Subcommittee on Financial Institutions and Consumer Credit,≅ (May 11, 2005).

corrective action. Another concern is that the new Accord does not assess a capital charge for interest rate risk, and therefore does not accurately adjust for the true riskiness of the institution. Further, the ability of the bank regulators to effectively supervise and monitor the new system has also been called into question.

One very controversial issue relates to the competitive benefits that the Basel II Accord may provide to covered banks compared to the rest of the industry. For example, one economic analysis estimated that the capital charge for prime mortgage loans with an 80 percent loan-to-value ratio could be as low as 29 basis points for Basel II banks.[9] If correct, this disparity in required capital would provide a significant competitive advantage for Basel II institutions, since a lower capital requirement for a product reduces the cost to offer that product. The result could be a gain of market share for products that receive a lower capital charge under the Basel II framework. Further, Basel II provides incentives for non-covered banks to concentrate on the riskier segments of the market within a product line (e.g. subprime loans), since the advantages of the Basel II system are diminished or even reversed as the riskiness of the credit increases. However, an increased concentration of riskier credits in smaller institutions would itself create risks for the banking system and deposit insurance funds.

Another concern is that Basel II may encourage further consolidation within the banking industry. To the extent that this new capital standard results in lower capital requirements for larger institutions, it makes these institutions more profitable for their shareholders and thus attracts additional capital that could be used to acquire less profitable banks. Moreover, the very act of acquiring a non-Basel II institution could free up additional capital for the acquiring bank. When a Basel II bank acquires a smaller institution, the newly acquired assets would become subject to the Basel II framework as a result of the acquisition, potentially freeing up capital that prior to the acquisition was needed to support the smaller bank=s operations. One estimate predicts that as a result of Basel II, consolidation in the banking industry could double the existing rate of consolidation.[10]

The Leverage Ratio

In addition to the risk-based capital standards, the U.S. agencies currently apply a Aleverage ratio≅ requirement to insured institutions. The leverage ratio is the non-risk adjusted ratio of tier 1 capital to total assets. The minimum leverage ratio is generally set at 4 percent (3 percent for certain highly rated banks).

It has been argued that even if the Basel II framework reduces a bank=s capital, the

---

[9] Calem and Follain, AProposed Competitive Impacts of Basel II in the U.S. Market for Residential Mortgages,≅ Statement Before the House Subcommittee on Financial Institutions and Consumer Credit≅ (May 11, 2005).

[10] Karen Shaw Petrou, ABasel II Regulation: U.S. Market and Competitiveness Implications,≅ Statement Before the House Subcommittee on Financial Institutions and Consumer Credit,≅ (May 11, 2005).

institution would still have to comply with the leverage ratio, thus mitigating competitive and other concerns. However, the leverage ratio only takes into account on-balance sheet assets. A large bank could effectively reduce the impact of its leverage ratio requirement through financial transactions that move assets off the institution=s balance sheet.

More fundamentally, the leverage ratio would appear to be inconsistent with the principles of the new standard, and arguably should be adjusted or eliminated for Basel II banks. The underlying rationale for Basel II is that it more accurately matches the capital of an institution to the risk presented by the institution=s assets. It is hard to rationalize requiring institutions to comply with the Basel II requirements, at a considerable cost to the institution, for the purpose of determining a more risk sensitive capital requirement, but then prevent the institution from actually benefiting from the new system by retaining a leverage ratio that does not recognize the true risk of the institution=s assets. This result would be harmful not only to the institution, but to the economy in general, since requiring a lending institution to hold Aexcess≅ capital will increase the cost of credit for the economy. It would also be harmful with respect to the global competitiveness of our international banks, since other Basel member countries will not be imposing a leverage constraint on their international financial institutions. In short, as a practical matter, if will be very difficult for the supervisory agencies to retain the leverage ratio in its current form for Basel II banks after the new Accord is implemented.

Current Status of Basel II Implementation

As previously mentioned, the Basel II framework was agreed to by the Central Banks and other bank supervisory authorities of the member countries on June 26, 2004. The Accord calls for the standardized approach to commence for non-U.S. institutions on January 1, 2007, and final implementation worldwide by January 1, 2008. Each member country is now proceeding to meet these deadlines pursuant to its own laws and customs.

In the United States, Basel II must be implemented through the issuance of new final regulations pursuant to the Administrative Procedure Act. As part of this process, the agencies issued an Advance Notice of Proposed Rulemaking on July 2003, as well as proposed supervisory guidance in October 2004 and in January, 2005. The original timetable called for the publication of a more formal notice of proposed rulemaking in the Summer of 2005.

On October 29, 2004, the U.S. banking agencies asked 26 large banking organizations to participate in a Aqualitative impact study≅ or AQIS≅ to determine the effects of the Accord. The results of this study, QIS-4, were released in the Spring of 2005. It indicates that the potential changes in capital that would be achieved under Basel II were significantly more substantial than previously estimated,[11] and that the bank=s calculations of key factors, such as the probability of a default and the loss given a default, differed widely for the same category of

[11] Changes in effective minimum required capital for individual institutions ranged from a decrease of 47 percent to an increase in 56 percent.

assets. In particular, QIS-4 found substantial reductions in capital for all but one category of wholesale and retail lending, and a large capital reduction for mortgage and home equity lending.

As a result, on April 29, 2005, the banking agencies announced a postponement in publication of the notice of proposed rulemaking, during which time the QIS-4 results will be further analyzed and studied. Once this analysis is complete, the banking agencies plan on continuing the rulemaking process with the publication of a proposed rule. Additionally, the agencies have announced plans to modify the Basel I standards applicable to the remainder of the industry. According to the Federal Reserve, the revisions to the Basel I standards are intended, among other things, Ato blunt the unintended harm that Basel II might impose on non-adopters.≅[12] Finally, on July 13, 2005 the Basel Committee announced that it Are-discussed the schedules of national rulemaking processes within member countries≅ and decided to review the Acalibration≅ of the new framework in the Spring of 2006. In connection with this review, the Committee decided to undertaken a new qualitative impact study (QIS-5) in October.

Conclusion

The current risk-based capital system needs improvement. It no longer effectively correlates capital and risk for many of our larger depository institutions. It creates perverse incentives for banks to sell or securitize their best assets and to retain riskier assets. It does not represent the state of the art in risk management or capital allocation. Basel II contains many improvements over the current capital framework system for our large and internationally active banks.

On the other hand, the proposed new framework may well cause unintended competitive effects with respect to non-Basel II institutions, and could also result in unexpected variations in capital requirements for similarly situated institutions. The task confronting our financial supervisory authorities is to extract the benefits of the new system while mitigating the potential for the unintended results.

While our very largest financial companies are capable of utilizing the advanced protocols of Basel II, there are many other depository institutions that could chose to use and benefit from the other models authorized by the international Accord, but rejected by the U.S. regulators. For example, implementation of the standardized approach (with modifications to reflect the unique nature of the U.S. financial system) would not only mitigate many of the potential anti-competitive effects of Basel II, but would also offer to all depository institutions in the U.S. the ability to be on the same level playing field as banks in Europe and Asia.

---

[12] Statement of Susan Bies, Member of the Board of Governors of the Federal Reserve System, before the House Subcommittee on Financial Institutions and Consumer Credit≅ (May 11, 2005).

In this regard, we note that the agencies are expected to unveil a proposed new capital standard for non-Basel II institutions, perhaps as early as this Fall. In developing this so-called "Basel I-A" option, the regulatory agencies should careful consider whether the proposed changes will be sufficient to meaningfully mitigate the anti-competitive effects of Basel II, and the extent to which the proposal will make capital requirements more risk sensitive for all institutions eligible to comply. At a minimum, the current four risk baskets could certainly be modified and expanded into additional baskets that more closely align with risk

It is also important for the agencies to use the rulemaking process to reduce, to the maximum extent possible, the formulaic nature of the new Accord and to provide discretion for banking organizations and the supervisory authorities adjust capital based upon the principle that capital should reflect the true risk of the institution. Thus, for example, the regulations should provide incentives for banking organizations to use the best methods possible for determining the risk of assets, even if those calculations differ from the formulas set out in the Accord. Likewise, the banking agencies should be able to modify capital requirements, either up or down, based on their supervisory judgment and examination of the institution. It is also important to allow the new system to be phased in over a period of time. This will permit the institutions and the regulators to monitor how the new system is impacting capital requirements. Considering the stakes involved, a go slow approach may well be the best approach, it will permit adjustments to the standards before unintended adverse consequences are widespread.

Finally, the regulators need to squarely face up to the fact that the current leverage ratio cannot be maintained after Basel II is implemented. The leverage ratio needs to either be phased out or significantly modified for those banks subject to the Basel II framework, and the recognition of this fact should be made part of the overall process of implementing the new framework.

Statement of

Independent Community Bankers of America
On

"Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study."

before the

Subcommittee on Financial Institutions and Consumer Credit

and the

Subcommittee on Domestic and International Monetary Policy, Trade and Technology

of the

Financial Services Committee

of the

United States House of Representatives

May 11, 2005

Independent Community Bankers of America
Washington, D.C.

The Independent Community Bankers of America appreciates the opportunity to submit this statement regarding the Basel II Capital Accord and how it should be implemented in the United States. Since Basel II will be the first significant revision of capital requirements since 1988 and will have a significant impact not only on the safety and soundness of the banking industry but also the overall U.S. economy, we fully understand and support the Committees' interest in this issue. Congress should maintain an oversight role in the Basel II process and should be kept apprised of any proposed revisions to the new accord.

Summary of ICBA's Position

ICBA recommends that the implementation of Basel II be delayed until the agencies can completely analyze the results of latest Quantitative Impact Study (QIS4), understand the competitive implications and determine what adjustments are needed to make the new accord more equitable. Because the elimination of the existing leverage ratio could jeopardize the safety and soundness of our financial system, we strongly support the retention of the leverage ratio once Basel II is adopted. Basel II should also be simplified so that regulators will be able to properly supervise and monitor it and Basel II banks will be able to comply with it. While we support the decision to apply Basel II only to the largest banks and not to community banks, we recommend that further changes to Basel I be made to make that capital accord more risk-sensitive and address the competitive inequities of Basel II.

Background and Current Status of Basel II Implementation in the United States

In June 2003, the U.S. banking regulators issued an Advance Notice of Proposed Rulemaking to begin implementation for Basel II in the United States ("ANPR"). The proposal formally set forth the U.S. regulators' position that Basel II would apply only to the ten to twelve largest U.S. banking organizations that have total assets of $250 billion or more or total on-balance sheet foreign exposure of $10 billion or more. Other institutions would have the opportunity to opt-in to Basel II provided they meet very strict eligibility standards. ICBA commented on the ANPR and expressed our concerns about the complexity of Basel II and the competitive inequities that would result if Basel II were implemented. ICBA also recommended further changes to Basel I to make that accord more risk-sensitive and address the competitive inequities presented by Basel II.

In June of 2004, the banking agencies described further their schedule for implementing Basel II in the United States. The agencies expected to issue a notice of proposed rulemaking (NPR) in mid-2005 and to release a final rule in mid-2006. In 2007, prior to implementation, the agencies expected to subject Basel II to a year of "parallel running," applying the framework in tandem with Basel I and in 2008, the new capital accord would be fully effective in the United States. The agencies also announced that they would be conducting a fourth Quantitative Impact Study (QIS4) to evaluate the

potential effects of implementation and to help banking organizations understand the competitive implications of the new accord.

However, on April 29, 2005, the agencies issued a joint press release stating that they have completed a preliminary analysis of the QIS4 submissions and that the results indicated "material reductions" in the aggregate minimum required capital for the large banks that participated in the study. The agencies stated that they need more analysis to determine whether the results stem from differences in risk, data limitations, flaws in the study, or whether the results mean further adjustments to Basel II are needed. The agencies did say that they remain committed to moving forward with the implementation of Basel II while retaining Prompt Corrective Action and leverage requirements and that they plan to continue to work under the existing implementation timeline for Basel II which calls for full implementation of the new accord by January 1, 2008. They announced that the NPR would be delayed until further work was completed on the QIS4 results.

The Implementation of Basel II Should be Delayed Until the Competitive Equities of the New Accord are Understood

ICBA supports the agencies' decision to delay further rulemaking under Basel II to give the agencies more time to analyze the results of QIS4. ICBA has expressed concern for a number of years, in previous testimony before this Committee and in our comments to regulators, that Basel II may place community banks at a competitive disadvantage. The Advanced Internal Ratings Based approach (A-IRB) of Basel II would yield lower capital charges for residential mortgage, retail and small business loans for Basel II adopters, the very credits where community banks compete with large institutions. An individual loan has the same risk to an institution whether a community bank makes the loan or a mega-bank makes it. It is not appropriate for the risk-based capital charge attendant to that loan to be widely divergent depending on whether the loan is made by a Basel I or a Basel II bank.

The results of the third Quantitative Impact Study (QIS3) issued two years ago heightened our concern at that time about the competitive equities of the new accord. That study showed that the risk weights and capital charges would significantly decrease for retail credits including mortgage and non-mortgage loans to individuals and small businesses. A later study by the FDIC issued in December of 2003 showed that risk-based capital requirements would be so significantly reduced under Basel II that many banks would fall under the minimum 4% leverage ratio that is required for a bank to be adequately capitalized. Capital reductions for mortgages would be particularly significant, dropping an average of 56 percent on 1-4 family residential mortgages.

Now that the preliminary analysis of QIS4 indicates that there would be material reductions in minimum required capital amounts among Basel II adopters, our concerns about the competitive inequities of the new accord are even stronger. For residential mortgage credits, the preliminary results showed that minimum capital requirements for Basel II adopters would drop an average of 73% for residential mortgage loans and 79%

for home equity loans. Currently, the minimum capital requirement under Basel I for these types of loans is 4% for well-capitalized banks. An average 73% or 79% drop would mean that minimum capital requirements for Basel II banks would be approximately 1% or less for these types of loans.

Since there is a cost to a bank for maintaining capital, the lower capital requirements would most likely result in a cost advantage, and correspondingly a pricing advantage, in retail credits for large banks that are subject to Basel II. The lower capital requirements will also make it easier for the Basel II banks to achieve a higher return on equity (ROE). In order to compete with the cost advantage and the higher ROEs of Basel II banks, community banks may be forced to make concessions in pricing and underwriting guidelines that could impair their profitability, and ultimately their viability.

ICBA also fears that Basel II will further accelerate the consolidation in the banking industry. Lower capital levels that large banks obtain under Basel II will likely result in more acquisitions of community banks and "second tier" regional institutions by the larger banks seeking to lever capital efficiencies. As more of the larger banks opt-in over the long-term, this could accelerate the consolidation of the industry even more, resulting in an undesirable loss of locally focused institutions better able to meet the needs of their communities. Since most community banks will remain under Basel I, they will have difficulty competing against bigger Basel II banks that benefit from reduced capital requirements and higher returns on equity. Basel I banks will become likely takeover targets for Basel II banks that believe they can deploy Basel I bank capital more efficiently. As more Basel I banks are left with riskier assets, lower credit ratings and higher costs of liabilities, they will find it more difficult to compete for the higher quality assets.

Community banks play not only a strong role in consumer financing in this country but also an important role in small business financing. Commercial banks are the leading suppliers of credit to small business, and community banks account for a disproportionate share of total bank lending to small business. Community banks account for 33 percent of small business loans, more than twice their share (15%) of banking assets. Because of the important role small businesses play in the economy (more than half the private sector workforce and two-thirds to three-quarters of new jobs), it is imperative to consider the competitive impact Basel II will have on community banks and their customers.

ICBA recommends that the implementation of Basel II be delayed until the agencies can completely analyze the results of QIS4, understand the competitive implications and determine what adjustments are needed to make the new accord more equitable.

The Leverage Ratio Should be Maintained Under Basel II

ICBA strongly supports maintenance of a capital-to-assets leverage ratio requirement for banks. For this reason, ICBA was pleased that the agencies' April 29th announcement stated their intention to retain Prompt Corrective Action and leverage requirements if Basel II is implemented. ICBA has been concerned with recent statements from Federal Reserve Chairman Alan Greenspan and others who have suggested that the leverage ratio would eventually be eliminated once Basel II was implemented.

ICBA believes that eliminating or reducing the leverage ratio could jeopardize the safety and soundness of our financial system and pose substantial risks to the FDIC insurance funds. In recent years, U.S. banks have been very sound and profitable. ICBA believes that the current economic health of our economy and financial system is partly due to the strong capital position of banks and the capital requirements, including the leverage ratio and prompt correction action requirements, implemented by regulators as a result of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

For instance, since 1989, the U.S. economy has experienced several economic downturns and recessions and banks have not only weathered these crises well but have served as pillars of strength for the economy. The healthy capital position of banks protected not only the banks themselves from financial problems but prevented these economic downturns from getting worse. In fact, Federal Reserve Vice Chairman Roger Ferguson stated recently that the capital levels that banks built up after the adoption of Basel I helped keep the 2001 U.S. recession relatively short and eliminated the threat of a vicious credit crunch or the risk of fragility in the system.

In ICBA's view, this is not the time for the regulators to be considering a reduction in the capital requirements when some of our largest financial institutions have been under investigation by federal and state authorities and, in certain cases, are having to restate earnings and reorganize their management. It is very important to our economy that regulators maintain a minimum capital cushion for our largest financial institutions that pose the greatest risks to our financial system. If a trillion dollar financial institution were to become significantly undercapitalized or fail, the consequences to our economy would be enormous. As former Comptroller of the Currency John Hawke said before the Senate Banking Committee, "Reducing the leverage ratio would undermine our whole system of prompt corrective action which is the foundation stone of our system of supervision…I think we need to reach an appropriate accommodation where we try to make our basic system of regulatory capital rules more risk-sensitive, but we shouldn't do that at the price of dismantling or significantly impairing the basis for our supervision of U.S. banks."[1]

[1] Testimony before the Senate Banking Committee (April 20, 2004)

Basel II Should be Simplified

ICBA has always been concerned about the complexity of Basel II and the ability of Basel II adopters to understand and implement the new accord as well as the consequences if a mistake is made. Our concerns were heightened recently when the regulators admitted to making a simple mistake (a misplaced square root sign) in one of the complex formulas that was included in a recent guidance on Basel II. It took over two months for the regulators to spot the mistake. If institutions followed the formula as it appeared in the guidance, required capital requirements for retail loans could have been significantly understated by as much as 60-70%.

This kind of mistake highlights the real world consequences of adopting a very complicated capital accord and having a regulatory system with the necessary expertise and skill to properly supervise and monitor it. Former Comptroller John Hawke once described Basel II as so complex, that it is "virtually impenetrable." Basel II is so complex that it will be challenging for both banks and regulators to maintain staff with the requisite Ph-D level expertise to understand the models and formulas and their assumptions and limitations. Furthermore, it is unrealistic to expect that the Basel II bank models will not contain errors or that regulators will be able to catch them in every instance.

Since small errors in the calculation of capital at these large institutions could have extraordinary consequences to our financial system, ICBA recommends that the Agencies consider ways of simplifying Basel II. Institutions that apply Basel II's A-IRB approach will have incentive to understate risk and losses in order to reduce capital requirements and increase return on equity. Therefore, the new accord and its capital formulas must not be so complex that regulators cannot readily spot intentional or unintentional errors or omissions in the formulas that are used. Basel II should also be simple enough that bank directors can monitor its implementation and auditors can certify to them as part of their internal control audits.

Basel II Should Not Be Applied to Community Banks

ICBA applauds the agencies for their plan to require application of Basel II only for the very largest, internationally active banks that meet certain infrastructure requirements. ICBA strongly supports the decision of federal bank regulators not to apply Basel II to noncomplex, community banks in the United States.

Methods of assessing capital adequacy must be appropriate to the size and complexity of operations of the bank. Bank consolidation in the United States has bifurcated the industry into a barbell shape with a few large, complex, globally active institutions on one end, and thousands of smaller, noncomplex, community-focused institutions on the other. In our view, capital adequacy regulations must recognize the differences between these two ends of the spectrum. The bifurcated approach to capital adequacy will better reflect banks' risk profiles, and avoid imposing unduly complex,

cumbersome or burdensome rules on community banks, without sacrificing safety and soundness.

Basel I Should be Changed to Enhance Its Risk-Sensitivity

ICBA recommends that further changes be considered for Basel I to enhance its risk-sensitivity and to address any competitive equity concerns associated with a bifurcated framework. ICBA support the regulators' intention to propose changes to Basel I simultaneously with the issuance of the NPR for Basel II. If this occurs, we hope that the agencies will propose additional risk categories to enhance the risk-sensitivity of Basel I and to align capital requirements with risk levels. The risk-weightings of these categories should also be modernized to better match current knowledge about actual risk exposures. For instance, lesser risk weights could be considered for rated credits and conforming mortgage loan products. Additional risk categories could be also added for loans with low LTV ratios.

However, we hope that any proposed revisions to Basel I or a new Basel I-A will not make the capital accord overly complex. The advantage of Basel I to community banks is its simplicity. Community banks are burdened enough with banking regulation and they do not want to comply with a very complex capital accord. Furthermore, regulators should also consider allowing well-capitalized, well-managed community banks the option to remain under the existing Basel I framework to reduce regulatory burden.

Proposed Legislation

ICBA supports H.R. 1226, the United States Financial Policy Committee for Fair Capital Standards Act, proposed by Chairman Bachus that would require a unified position among the regulators on Basel II. Although we expect that the regulators will eventually reach a consensus on Basel II, we do support Congressional oversight of this process as contemplated by the proposed legislation. It is essential that the Basel II revisions be done correctly since they will impact not only the safety and soundness of the industry but the well being of the economy in general. Congress should be kept apprised of the proposed revisions and should be consulted about their cost and complexity as well as their impact on competition between banks and other financial institutions. We also support giving the Director of the Office of Thrift Supervision equal representation with the other three bank regulators on the Basel Committee.

Conclusion

ICBA supports the decision of the regulators to postpone the implementation of Basel II and recommends that the implementation of Basel II be delayed until the agencies can completely analyze the results of QIS4, understand the competitive implications and determine what adjustments are needed to make the new accord more equitable. Because of the important role that community banks play as consumer and small business lenders, it is important that the regulators take their time to analyze the

data from the QIS4 and make the adjustments to Basel II that are necessary so that when the new accord is implemented, there is no adverse impact to community banks or their customers and communities.

ICBA also supports the retention of the leverage ratio for Basel II. Eliminating or reducing the existing leverage ratio of 5% for well-capitalized banks, in our opinion, would jeopardize the safety and soundness of our financial system. We also recommend that the regulators simplify Basel II so that regulators will be able to properly supervise and monitor it. Finally, while we support the decision to apply Basel II only to the largest banks and not to community banks, we do recommend that further changes to Basel I be made to make that capital accord more risk-sensitive and address the competitive inequities of Basel II.

Thank you for the opportunity to present our views on this important topic.

Board of Directors

Chairman
Robert J. Lowe
Chairman and CEO
Lowe Enterprises, Inc.

President and CEO
Jeffrey D. DeBoer

Secretary
Daniel M. Neidich
Chairman and Co-CEO
Dune Capital Management LP

Treasurer
Penny Pritzker
President
Pritzker Realty Group, L.P.

Robert M. Couch, CMB
President and CEO
New South Federal Savings Bank
Immediate Past Chairman
Mortgage Bankers Association

John C. Cushman, III
Chairman
Cushman & Wakefield, Inc.

Steven W. Ford
Senior Managing Director/Facilities
Cushman & Wakefield, Inc.
Chairman and Chief Elected Officer
Building Owners and Managers
Association, International

Joseph W. Luik
Principal
Joseph W. Luik, LLC

Al Mansell
Consultant to the President
Coldwell Banker Residential Brokerage
President
National Association of Realtors

James E. Maunn
Chairman
Stirling Properties
Chairman, International Council
of Shopping Centers

Christopher Nassetta
President and CEO
Host Marriott

Quintin E. Primo, III
CEO
Capri Capital

Nelson C. Rising
Chairman and CEO
Catellus Development Corporation
Immediate Past Chairman
The Real Estate Roundtable

Douglas W. Shorenstein
Chairman and CEO
Shorenstein Company, LLC

David Simon
CEO
Simon Property Group
Chairman, National Association of
Real Estate Investment Trusts

Jerry I. Speyer
President and CEO
Tishman Speyer Properties

Robert S. Taubman
Chairman, President and CEO
Taubman Centers, Inc.

Joseph S. Taylor
President and CEO
Matrix Development Group
Chairman, National Association of
Industrial and Office Properties

Richard S. Zeman
Chairman and CEO
Arden Realty, Inc.

The Real Estate Roundtable

May 10, 2005

The Honorable Spencer C. Bachus
Chairman, Subcommittee on Financial Institutions and Consumer Credit
United States House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515-6051

The Honorable Deborah Pryce
Chairman, Subcommittee on Domestic and International Monetary Policy,
Trade and Technology
United States House of Representatives
B-304 Rayburn House Office Building
Washington, DC 20515-6058

Re: Comments on the New Basel Capital Accord

Dear Chairmen:

The Real Estate Roundtable (www.rer.org) is providing these comments to the House Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Domestic and International Monetary Policy, Trade ("Committees") on the New Basel Capital Accord ("New Accord"), in conjunction with their joint hearing on May 11, 2005.

The New Accord could have a significant negative impact on the flow of credit to the commercial real estate industry and, thereby, affect its overall liquidity and valuation. As such, we appreciate the opportunity to provide the Committees with our concerns about the New Accord.

The Real Estate Roundtable and its members lead an industry that generates more than one–third, or $2.9 trillion, of America's gross domestic product, employs more than 9 million people, represents capital investment of over $4.6 trillion, and produces 70 percent of the taxes raised by local governments for essential public services. Our members are senior real estate industry executives from the nation's leading income-producing real property owners, managers and investors, the elected heads of America's leading real estate trade organizations, as well as the key executives of the major financial services companies involved in financing, securitizing or investing in income producing properties.

Unintended Consequences of the New Accord

The Real Estate Roundtable ("the Roundtable") would like to commend the Committees for their work toward examining the work of the Bank for International Settlements and the corresponding work of the U.S. regulatory agencies. Clearly, there are benefits to a more fair and consistent conceptual risk capital framework in our global financial services system. By more closely aligning regulatory capital with economic capital, the New Accord has the potential to improve the relative allocation of capital to more closely reflect actual differences in risk.

1420 New York Avenue, N.W. • Suite 1100 • Washington, DC 20005 • Phone: 202-639-8400 • Fax: 202-639-8442 • www.rer.org

While the Roundtable believes that the New Accord makes significant progress toward greater risk transparency, we also have serious concerns about the potential for significant unintended consequences — both for the real estate sector and the overall economy — that an inappropriately calibrated new regulatory capital regime can generate. Specifically, we are concerned that the capital requirements for commercial mortgage securities and commercial real estate acquisition, development and construction (ADC) loans, are sufficiently high as to have the unintended and unnecessary consequence of being a disincentive for those markets. The Roundtable believes that the New Accord should be constructed with the intent of having a neutral effect on these financial activities.

Commercial Banks Vital to Real Estate Credit Availability

Commercial bank lending is the principal source of credit for U.S. commercial and multifamily real estate. Bank underwriting standards have improved since the last economic cycle, resulting in more realistic loan-to-value requirements, more accurate estimates of future cash flows, and more proactive management of non-performing assets. In addition, federal regulatory agencies have provided stronger regulatory oversight of the sector.

Real estate's increasing role in global capital markets – through securitization vehicles such as commercial mortgage backed securities (CMBS) and real estate investment trusts (REITs) – has led to greater transparency, enhanced liquidity, better discipline and more exacting scrutiny of commercial real estate asset quality. As a result, the process for disclosing market information has become more defined, the quality of information required by both regulators and investors has improved, and the speed with which property performance information is available has accelerated.

Increased Regulatory Capital Could Strain Real Estate Credit Availability

The U.S. commercial real estate market has proven to be strong and a key driver of our economy. We are concerned that Basel II could require a 25% risk weight increase for some ADC loans. This is highly problematic as it could drive banks out of this type of lending, thereby stifling economic growth. There have been tremendous advances in the assessment of risk for this type of lending, unfortunately the Basel Committee is not taking into consideration these important advancements and is applying an unsophisticated standard for the risks associated with an important lending sector.

As such, the new capital standards for commercial real estate are expected to unsettle, and perhaps substantially disrupt, real estate credit, and could create a very difficult environment for the commercial real estate banking industry within the next few years.

The Roundtable generally supports the U.S. regulatory agencies' efforts at developing a more balanced and consistent conceptual risk capital framework for the nation's banking system. We also encourage standards by which real estate lending is sensibly underwritten and economic risk is appropriately priced. However, certain capital increases proposed in the New Accord, coupled with rules that are not directly linked to economic risks, could have negative consequences for lending to real estate.

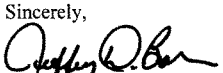
In the past decade, residential and commercial real estate have been pillars of the nation's economy. Yet reduced credit availability for real estate, particularly in a weakening economy, could be expected to undermine overall market liquidity and diminish property values. The Roundtable strongly urges the Committees to request additional comments on the impact of the proposed accord on the U.S. economy and affected industries and to provide the opportunity for continued industry comment on additional changes to the New Accord necessary to mitigate the sectoral and macroeconomic concerns.

To this end, The Real Estate Roundtable supports the "United States Financial Policy Committee for Fair Capital Standards Act" (H.R. 1226). This legislation would establish a mechanism for developing uniform U.S. positions on issues before the Basel Committee on Banking Supervision at the Bank for International Settlements and require a review of the most recent recommendation of the Basel Committee relating to potential implementation of the New Accord. Perhaps the most important feature of this legislation for real estate is its provision to require the federal bank regulatory agencies, in consultation with the Secretary of the Treasury, to evaluate the potential impact of the New Accord on real estate markets as a condition for approving its implementation. We are pleased to commend Chairman Bachus and the 35 co-sponsors for introducing this important legislation.

We trust the Committees may find our comments useful. Should you have questions or require additional information, please contact Clifton E. Rodgers, Jr. by telephone at (202) 639-8400 or by email at crodgers@rer.org.

Thank for this opportunity to comment on this important issue.

Sincerely,



Jeffrey D. DeBoer
President and Chief Executive Officer

cc: The Honorable Michael G. Oxley
Chairman, House Committee on Financial Services

The Honorable Richard C. Shelby
Chairman, Senate Committee on Banking, Housing and Urban Affairs

NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

REALTOR®

500 New Jersey Avenue, N.W.
Washington, DC 20001-2020
202.383.1194 Fax 202.383.7580
www.realtors.org/governmentaffairs

Al Mansell, CRB
President

Terrence M. McDermott
EVP/CEO

GOVERNMENT AFFAIRS
Jerry Giovaniello, Senior Vice President
Walter J. Witek, Jr., Vice President

Statement of the

NATIONAL ASSOCIATION of REALTORS®

on

Basel II: Capital Changes in the U.S. Banking System

and the Results of the Impact Study

For Submission to the

Subcommittee on Financial Institutions and Consumer Credit

and the

Subcommittee on Domestic and International Monetary Policy,

Trade and Technology

of the

House Financial Services Committee

May 11, 2005

Introduction

The National Association of Realtors® ("NAR") is pleased to submit this Statement for the Record to the above House Financial Services Subcommittees on the Basel II Capital Accord ("the Accord"). We appreciate the time and effort that its members, including Committee Chairman Michael Oxley and Subcommittee Chairs Spencer Bachus and Deborah Pryce, have spent on this very important issue, and we look forward to working with you to address the concerns that we have with the Accord.

NAR is the nation's largest professional trade association with almost 1.2 million members who belong to over 1,500 REALTOR® associations and boards at the state and local levels, as well as various institutes, societies and councils designed to enhance their expertise in real estate.

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics.

EQUAL HOUSING OPPORTUNITY

NAR's members include brokers, salespeople, property managers, appraisers and counselors, as well as others engaged in all aspects of the real estate industry.

Our Position

NAR supports the overall goal of the Accord; however, we believe that the Accord should not skew lending away from real estate and are concerned that:

- Its potential effect on the real estate industry is not yet clear.
- Its treatment of high volatility commercial real estate ("HVCRE") loans could unnecessarily slow down that segment of the industry.
- Its treatment of commercial real estate does not adequately capture loans on properties that have partial equity or are partially pre-leased or pre-sold.

As a result, we support the *United States Financial Policy Committee for Fair Capital Standards Act of 2005* (H.R. 1226) that would create an interagency committee of federal financial regulators to study and report on the Accord's potential impact on the economy, including the real estate industry.

Real Estate is an Important Part of our Economy

The federal regulators that comprise the Financial Policy Committee – the Federal Reserve Board, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Federal Deposit Insurance Corporation – should make sure that the Accord does not directly, or indirectly, harm our nation's real estate market or the hundreds of thousands of associated real estate professionals.

NAR is concerned that changing the reserve requirements of certain types of lending may create an incentive for banks to direct their lending away from real estate, and thereby potentially slow or dampen the flow of credit to this vital economic sector.

The real estate industry is one of the driving forces of our national and local economies, as it contributes significantly to homeownership, employment, development, retail sales and tax revenues. Commercial real estate, in particular, has proven to be fundamentally strong and has helped our nation recover from several recent negative events, including the downturn in the technology sector, stock market declines, accounting scandals and the September 11 terrorist attacks.

The New Accord Would Take Effect in 2008

In 1998, the Switzerland-based Bank for International Settlements decided to revise its 1988 Basel I Capital Accord to better reflect underlying economic risks and create a more stabilized international banking system. The new Accord is being developed by top central banking officials of the Group of 10 (G-10) nations, and would be fully effective in January 2008.

The largest U.S.-based, internationally-active banks would have to comply with the new standards of the Accord. Other banks could voluntarily "opt in" if federal regulators approve their risk management measures; however, only a few are expected to do so due to high compliance costs. Banks not subject to the new Accord would remain subject to the capital standards of the original Basil I agreement (which federal regulators plan to update as well).

The Accord contains three main components, or "pillars." Pillar 1 establishes minimum capital reserve requirements (based on complicated formulas relating to both credit and operational risks) to protect against potential losses; Pillar 2 creates an enhanced review process of an institution's loan policies and capital reserves; while Pillar 3 imposes improved public disclosure requirements.

The Overall Effects of the Accord Need to be Better Understood

Preliminary analyses of the most recent Quantitative Impact Study (QIS4) show that banks with similar assets and risk profiles would have widely different capital requirements under the Accord. For example, some banks have estimated that their overall capital requirements (for all types of loans) would drop between 20 and 40 percent, while others have estimated they would actually increase by up to 60 percent. Capital requirements for specific types of loans (commercial and non-commercial) could vary even more dramatically.

As a result of this unexpected and unsettling data, federal regulators decided to postpone their Notice of Proposed Rulemaking so they could have more time to evaluate QIS4. NAR supports this decision and believes that the Accord should not be implemented in the United States until it has been thoroughly examined and modified to eliminate potential disruptions to the commercial real estate market and the broader economy.

The Accord Could Hinder Certain Types of Commercial Real Estate

NAR is concerned that the Accord could have unintended and undesirable consequences for the commercial real estate industry. Pillar 1 would appear to increase the capital reserve requirements for certain real estate loans, specifically those relating to HVCRE – properties that are purchased for acquisition, development and construction (ADC) and do not have "substantial equity" or are not "sufficiently pre-leased."

As a result, banks would have less incentive to make HVCRE loans because more capital reserves would have to be put aside to cover potential losses. To the extent banks decide to make such loans, they would probably charge higher interest rates to offset their higher reserve requirements, which in turn would create a disincentive for investors and developers to acquire HVCRE property. Funds that would otherwise go to HVCRE loans would most likely be redirected to other types of loans that have lower reserve requirements, including those relating to income-producing real estate (IPRE), non-commercial real estate and corporate bonds

In addition, the terms "substantial equity" and "sufficiently pre-leased" should be better defined so partially-sold or partially-leased ADC properties can be clearly classified as HVCRE, IPRE or a newly-created category.

The Accord Would Revise the Risk Formula for HVCRE Loans

The Accord would restructure the formulas that banks use to determine default risks for certain classes of real estate, including HVCRE. It would incorporate asset correlation variables that are designed to measure the likelihood that a particular default(s) would trigger a broader downturn in that asset class or industry sector.

For example, properties specifically geared towards one particular industry or use (e.g., resort hotels) would be more susceptible to market fluctuations in that industry. Under the Accord, these types of properties would have a higher asset correlation value (and considered riskier) than properties that have multiple uses or can be leased to various types of tenants (e.g., retail stores).

Absent evidence that existing HVCRE loans do not adequately account for market susceptibilities, these loans should not be treated differently under the Accord than they are now. Underwriting standards and appraisal procedures for HVCRE loans have improved dramatically over the past decade, and many of them are securitized (allowing for greater transparency, liquidity and scrutiny by federal agencies). Securitized vehicles include commercial mortgage backed securities (CMBS), real estate investment trusts (REITs) and real estate mortgage investment conduits (REMICs).

HVCRE has played an important role in the growth of commercial development across our country; therefore, related loans should not be discouraged through the revision of risk formulas.

Legislation Would Create an Interagency Committee to Review the Accord

NAR supports legislation recently introduced by Chairman Spencer Bachus – the *United States Financial Policy Committee for Fair Capital Standards Act* (H.R. 1226) – that would create an interagency committee (consisting of the federal banking regulators and the Secretary of the Treasury) assigned to develop uniform positions on the Accord's provisions and report to Congress before it could be implemented in the United States. This bill also would require the Committee to evaluate the effects the Accord would have various sectors of the economy, including the real estate industry. If the members of the Committee cannot agree on an issue, the Secretary of the Treasury would decide.

H.R. 1226 should be enacted as soon as possible so federal regulators can collectively review the Accord, determine its potential adverse effects to the commercial real estate industry and modify relevant provisions prior to its implementation. NAR and its members look forward to working with the Financial Services Committee and its Subcommittees to advance this legislation in both the House and Senate.

Conclusion

Commercial real estate has been a stable and important component of our economy and should not be harmed or weakened by the Accord. Therefore, NAR supports H.R. 1226 and encourages

Congress and federal regulators to ensure that certain types of commercial property would not be negatively affected.

We appreciate this opportunity to express our views on this very important matter.

Financial Guardian Group

900 Seventeenth Street, N.W., Suite 506
Washington, D.C. 20006
Phone: (202) 296-5240
Fax: (202) 452-6816

Karen Shaw Petrou
Executive Director

June 30, 2005

Hon. Spencer Bachus
Chairman
Subcommittee on Financial Institutions and Consumer Credit
Financial Services Committee
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Bachus:

Thank you for the opportunity to respond to your questions regarding my recent testimony on Basel II and the QIS-4 before the Financial Institutions and Consumer Credit and Domestic and International Monetary Policy, Trade, and Technology Subcommittees. Implementation of the new Basel Capital Accord in the U.S. will have widespread ramifications for both consumers and the financial services industry, and your continued review of the implementation process has increased the likelihood of the Accord's careful and successful implementation. Below, I provide responses to each of your nine questions.

1. *The argument has been made that regulatory capital arbitrage is not necessarily a bad thing when it moves risk out of the banking system. Please comment on this view. Should the Committee be concerned that the competitive disparities created by the operational risk-based capital charge could lead to the movement of assets outside the banking system?*

The U.S. system of banking regulation is among the most robust and sophisticated in the world. As a result, it is troublesome that banks may be forced to move assets outside the system, or even to de-bank – that is, terminate their charters and take advantage of other structural options. The large number of nonbank competitors in lines of business such as asset management or payments processing could well lead banks that specialize in these lines to consider all strategic options. This would increase overall systemic risk as regulatory oversight would decrease or, in some cases, be eliminated. For example, as this Committee well knows, the Fed has adamantly argued that industrial loan companies be brought under full banking regulation because of the fear that lax supervision could create systemic risk. Further, the purchase of specialty banks by large, diversified banks would result in more concentration risk.

2. *Some maintain that U.S. investment banks are under a regime comparable to the Basel II framework, which has been imposed on them by the SEC. Is this characterization of the SEC regime correct? Are there any aspects of the SEC's standards that should raise concern? Does the SEC regime solve the bank/nonbank competitiveness problem?*

The SEC's capital framework for consolidated supervised entities (CSEs) has been repeatedly described as comparable to Basel II. However, in reality, it differs sharply from the Basel standards expected to be imposed on banks in the U.S. in a number of significant respects. For example, the CSEs will not be subject to minimum capital requirements, nor will they be governed by any leverage capital standards. In addition, the SEC will allow CSEs to use their own internal credit risk weightings if the Basel II ones are problematic. They can also use the more simple approaches to operational risk-based capital, which could prove less costly than the advanced approach (which is the only one allowed for banks in the U.S.). Perhaps most importantly, because of size requirements, the CSE regime will only apply to the very largest, approximately five or six, investment banks. It is important to note that nonbank mutual fund companies, payment processors, asset managers and transfer agents, despite competing in the same lines of business as many banks, will not fall under any comparable requirements. Of the top 50 institutional asset managers, 37 are nonbanks. Of these 37, I believe only three or four will fall under the SEC's CSE regime.

3. *Can you explain what a "low hanging fruit" approach to Basel II implementation would entail? Is this a viable approach to implementing the Accord in the U.S.?*

There is wide agreement on some of the most obvious problems with the current risk-based capital rules. For example, there is general consensus that risk weightings for residential mortgages are too high under Basel I. In addition, the treatment of corporate debt instruments is not risk sensitive and can create incentives to hold riskier assets in portfolio. There are simple solutions to these problems, and it is my understanding that the regulators are attempting to answer these more obvious problems in a rewrite of Basel I for smaller banks. I would suggest making this "Basel Ia" available for all institutions. Once these problems are fixed, the regulators can then turn to developing and, more importantly, assessing the competitive impact of the more advanced approaches.

4. *Would an operational risk-based capital charge like the one now proposed have done anything to prevent recent losses due to operational risk, such as the Barings case, where a rogue trader brought down the entire bank, and even the Citigroup legal risk reserves in the wake of Enron, WorldCom and other problems. Have any banks besides Barings ever failed because of operational risk?*

The important thing to note with regard to the Barings loss is that it was a case of criminal fraud, due to the very basic failure to segregate duties. I am not sure of any way to devise a capital charge for criminal fraud. Effective internal controls – which are actually undermined by an operational risk-based regulatory capital charge – are the best way to prevent these types of losses.
Strengthened internal controls would have ensured the trader was caught – and possibly would have even dissuaded him from committing the initial fraudulent act – before the losses reached their ultimate levels. With regard to whether other banks have failed due to operational risk? I am not aware of any. For example, on September 11, it was the investments in detailed processes and

procedures, insurance, extensive training, redundant backup systems, not a capital charge that allowed the U.S. financial services industry to recover so quickly.

5. *Interest-rate risk was a significant – if not the main – contributor to the collapse of the U.S. savings and loan industry, costing taxpayers about $200 billion. How is interest-rate risk treated under Basel II?*

Interestingly, an express capital requirement is not required for interest-rate risk despite, as you note, its principal role in the collapse of the S&Ls in the 1980s and multiple bank failures before and since the S & L collapse. Despite interest-rate risk pricing in the market every day, bank regulators assert that they are more comfortable with a supervisory approach to interest-rate risk. This treatment of interest-rate risk is warranted, and it is clear to me that operational risk, which is not nearly as well understood or measurable, should receive similar treatment under Pillar 2.

6. *Is there a link between the legal risk component of the operational risk-based capital charge and U.S./EU competitiveness? Treatment of this risk is of particular concern to the U.S. because of laws intended to further important U.S. social policy objectives. How should the regulators implement the Accord without penalizing U.S. banks for this country's focus on these important social policy initiatives?*

Legal risk should be addressed through supervisory standards, not a Pillar 1 capital charge. U.S. banks – unlike EU ones – already reserve for known legal risk and otherwise manage this very well. A capital charge based on unique U.S. standards against loan discrimination, for example, is punitive and has no offsetting safety-and-soundness benefit.

7. *Many commentators have expressed concerns regarding the creation of an "unlevel playing field" due to high levels of national discretion contained in the new Basel Capital Accord. Is there a serious likelihood that Basel will not be applied uniformly around the world?*

This is a very real concern, especially in the area of operational risk. There is a huge amount of supervisory discretion in the advanced Basel approaches, which make the regulatory approach meaningless if supervisors are not diligent or don't have appropriate enforcement tools. It is important to reiterate here that the U.S. system of supervision is among the most robust in the world. Large banks, which will adopt Basel II, have numerous supervisors from the Fed, FDIC and/or OCC actually working out of the regulated banks' offices. With the exception of several extremely large international banks, this is not the case in other countries.

8. *What is your position on H.R. 1226?*

I appreciate Congress' strong interest in Basel and the desire for a coherent, coordinated U.S. position – and this interest is critically important. Although the Accord appears to be finalized, I was encouraged to hear Ms. Williams remark that the OCC would push for changes to the Accord if necessary. I am hopeful that Congress will use its influence to ensure the U.S. regulators do so in Basel and ensure that their final rules implementing the Accord do not adversely impact U.S. banks. If there is no progress in the U.S. rulemaking process on key competitive points, then H.R. 1226 should

be revised to mandate Pillar 2 treatment of operational risk and other critical revisions to the current proposal.

9. *The Federal Reserve Board has done a preliminary study on the effect of Basel II on mergers and acquisitions activity within the banking industry as well as one on the impact of the operational risk-based capital charge. Please comment on these two studies.*

With regard to both studies, I have to agree with the Fed's disclaimers and otherwise question the studies' conclusions. U.S. regulators must err on the side of caution with regard to Basel II. If these competitiveness issues are not resolved prior to implementation, any adverse impact cannot be undone. One simply cannot quickly dissolve a merger or revive a failed business line. Basel II has already been seen as the cause of one major EU acquisition, with a Wall Street analyst suggesting the Accord could be the "weapon of choice" in bank M&A.

I want to thank you again for the opportunity to further comment on this critical issue. Please do not hesitate to contact me in the future as the process to implement Basel II in the U.S. continues.

Sincerely,

Karen Shaw Petrou
Executive Director

O