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

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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.