Testimony of

America's Community Bankers

on

"The New Basel Accord: Private Sector Perspectives"

before the

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and Consumer Credit

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Mr. Chairman, Ranking Member Sanders, and members of the Subcommittee, my name is Kathleen M. Marinangel. I am Chairman, President and Chief Executive Officer of McHenry Savings Bank, a $210 million institution in McHenry, Illinois. The primary business lines of the bank are focused on the retail customer and a significant portion of the assets of the bank is single-family mortgages. For reasons that I will describe later, in the last decade our business strategy required that we invest in a more diversified mix of assets, including adjustable commercial real estate and consumer loans. These products can be repriced more frequently and flexibly to take account of interest rate swings.

I am testifying today on behalf of America's Community Bankers, where I serve as a member of the Board. I also serve on several committees and on the Basel II Working Group. Thank you for this opportunity to testify on the impact that the Basel II Accord 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. I believe that the development and implementation of the Basel II Accord is one of the most important regulatory initiatives for community banks today. However the banking regulators in the United States craft requirements for insured depositories in the United States, the result will impact capital levels and what is necessary to measure capital. The business of every community bank will change in some way as a result of the Basel II Accord.

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

I think that is a shame. My perspective is that of a CEO of a small community bank that does not currently have the resources to voluntarily opt in to Basel II's advanced internal ratings-based formula for determining capital levels. Under the current proposal, my institution would remain subject to Basel I. If it were economically feasible, I would strongly recommend that my bank "opt-in" to Basel II. In fact, ACB believes that any financial institution that has the resources should be able to opt into 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.

An alternative that ACB has advocated in its letters to the banking regulators is 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 and make changes to the current capital requirements. The purpose of these changes would be to alleviate some of the disadvantages for community banks and more accurately reflect each bank's actual risk levels that ACB and others believe will develop with the implementation of Basel II for the largest banks. In fact, the federal banking agencies announced just last week that they have decided to do just that. They have indicated that resources have been earmarked for a project that will propose revisions to the current risk based capital requirements.

Before I address some of ACB's concerns with the Basel II Accord in more detail, I would like to describe why the implementation of the capital requirements and risk management is important to me as a community banker. While there are a number of risks involved in determining risk based capital, an important one is interest rate risk. Because of the interest rate volatility in the past 25 years, many community bankers have had to develop strategies to manage the risk that include changing their business model.

To better understand my position on the importance of the ability to accurately allocate risk for capital purposes, let me give you some background on my bank's history. McHenry Savings Bank is a survivor of the high interest rate cycle of the late 1970's and early 1980's. At that time, the bank's assets were primarily 25-year, fixed-rate mortgage loans. Liability rates rose to historically high levels in the range of 18 percent while the mortgage loans held in portfolio maintained an average yield of less than eight percent. Management of the bank was aware that the inability to reprice assets was an important cause of the failure of many banks. While the credit risk of mortgage loans was and continues to be low, the interest rate risk of that same mortgage portfolio is very high.

The management and board of McHenry Savings Bank adopted a strategic plan that included a goal to diversify assets in such a way that the bank would never again rely on one type of asset in its loan portfolio. An important factor in developing this strategy was that the bank has the ability to reprice those assets as often as possible. Management and the board of the Bank realized that flexibility in repricing was a key to survival in times of fluctuating interest rates. For several years, the bank repriced 80 percent of its assets annually. The portfolio mix that we decided was optimal ultimately consisted of consumer loans equal to 25 percent of assets, commercial loans and commercial real estate loans equal to 20 percent of assets and the rest and of the portfolio is shorter duration mortgage loans and investments. Because commercial loans floated daily with prime rate and one-third of the consumer loans repriced annually, we knew that portfolio interest rate risk was minimized.

Shortly after completing the restructuring our portfolio, in 1988, the Basel Committee on Banking Supervision implemented the Basel I Accord. This risk-based capital formula created a standardized system for risk weighting of assets. Management of McHenry Savings soon realized that as a result of the restructuring of assets the bank did not meet the risk-weighted requirements adopted by the federal banking regulators to implement Basel I. Unfortunately, the simplicity of the formula did not enable banks to determine the true risk of assets. No consideration was given to collateral value or loan-to-value of assets. From the beginning, a more diverse formula was needed. A number of minor changes have been made over time, but the general requirements are the same today as they were when first adopted. Moreover, advances in risk management techniques have magnified the inadequacy of the Basel I formula.

I personally have sent letters to over two thousand bankers, regulators and legislators over the years asking for modifications to this formula to more truly reflect the risk of assets held in portfolio. 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. More than the current four buckets are necessary and consideration must be given to collateral values and loan-to-value ratios. 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.

Now that some large U. S. banks and international banks will have the ability to adopt the new Basel II Accord, it is time to address the shortcomings of the Basel I risk-based formula by which the community banks will have to abide. Without change, many community banks will be required to hold capital under the current capital requirements that is higher than that of more risky institutions.

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. Bank buildings are currently weighted at 100 percent, thereby giving no value to this strong asset. More examples are illustrated in Appendix A as attached.

The formula assumes that fixed rate mortgage loans are less risky than commercial real estate loans. Mortgage loans are weighted 50 percent while commercial loans are weighted 100 percent. The credit risk of a fixed rate mortgage loan may be less than the credit risk of a commercial loan, but the interest rate risk of the mortgage loan will be higher than an adjustable rate commercial loan, particularly in today's new rising rate environment. Just as in the late 1970's, in a rising rate environment, fixed rate mortgages will not reprice and the duration of the loans will lengthen. The current formula does not address this interest rate risk.

Basel II Accord

With that background, 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. 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 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 most recent version of Basel II is less detailed than previous versions, it remains an extremely complex document. 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 legislators, regulators and the industry need to evaluate the complexity of the proposal and the ability to monitor compliance prior to implementation. 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 are pleased that the U.S. regulators have proposed to leave a leverage requirement in place. While there may be some legitimate dispute about the proper level of that requirement, a regulatory capital floor should remain in place to mitigate the imprecision inherent in internal ratings-based systems. I will address later in my testimony the impact that the complexity of the proposal has on the ability of a community bank to opt in to the proposal.

Competitive Concerns

A new capital accord should treat similar risks comparably from institution to institution to avoid creating competitive inequities. The most recent quantitative impact study conducted by the Basel Committee on Banking Supervision shows that the new accord could result in significant capital savings for some of the largest banks and savings associations in the United States and other countries. While the study was based on incomplete information, it does give us a preliminary look at what the impact of Basel II could be. The study shows 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.

We understand that the U.S. bank regulators intend to conduct their own quantitative impact study, and we will be interested in seeing the approach that the study will take. We also are pleased that the Federal Reserve Board is now utilizing resources to review and analyze the competitive effects of a bifurcated capital system on several different product lines as well as on merger and acquisition activity. The Federal Reserve has completed its study on the small- and medium-size business loan market and on the impact of the proposal on further industry consolidation. While we do not necessarily agree with the conclusions of the studies, we appreciate the efforts being extended and will look forward to seeing the Federal Reserve's planned study on the mortgage product line. We also are retaining our own experts to more carefully review the Federal Reserve studies and separately analyze the competitive impact of Basel II.

While nobody can say with certainty at this time what the impact of a bifurcated system will be, one can assume that it will open the door to competitive inequities. Under that 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. What was required capital at the acquired bank would be excess capital if I had a lower capital requirement, the equivalent of printing money from my perspective. 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 less capital in order to provide more competitive pricing.

The competitive effects discussed above are exacerbated by the current "all or nothing" approach to the proposed implementation in the Untied States. Institutions opting in to the new accord not only must implement the complex and expensive internal ratings-based approach, but also must do so across all asset classes in order to realize even the most obvious benefits of the new accord. Also, if an institution cannot meet the significant burden of adopting both the internal ratings-based approach to calculating credit risk and the advanced measurement approach to measuring operational risk, there is no ability at all to align capital more closely with balance sheet risk.

Community banks must retain the option to leverage their capital, regardless of the complexity of the calculations, to improve their ability to manage risk. Whether the choice is to implement Basel II or a revised, more risk sensitive Basel I, community banks must be given the opportunity to compete against the international banking giants. These large banks have branches in many communities across the country, and compete directly with community banks.

ACB does not believe that the new accord should be implemented in the United Statues until more information is gathered and analyzed about the competitive effects. If studies show that smaller banks will be harmed competitively, steps need to be taken to address the inequity, including making changes to Basel I and making it easier for smaller banks to opt in to Basel II. Otherwise, these inequities will only add to the other disadvantages under which community banks operate and threaten the ability of community banks to survive.

Alternative Proposals

If Basel II is implemented for a portion of the banking industry, changes must be made at the same time to Basel I to maintain similar capital requirements for similar risks. One approach would be to revise the current accord to make it more risk-sensitive for all institutions, and then add more complexity to capture any additional risk at more complex and sophisticated institutions. 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. One example of how assets could be treated under a more refined Basel I is set forth in Appendix A. The approach would be relatively simple for banks to implement and for regulators to supervise. This example is just one approach. Any effort to refine Basel I for all institutions should be a collaborative effort between banking supervisors and the banking industry. There is still time to proceed in this direction before Basel II is implemented at the end of 2007.

Another option would be to give more U.S. financial institutions the proper incentives to continue to improve risk management practices and thereby reap the benefits of more risk-sensitive capital requirements. My institution and many other community banks would like the opportunity to improve their risk management practices to such a degree that we can use our internal assessment of risk to determine adequate capital levels. ACB believes that the complexity of Basel II and the significant obstacles to opting in to benefit from more risk-sensitive capital requirements are not warranted. Most community banks simply do not have the resources necessary to meet the significant eligibility standards proposed in Basel II for adopting an internal ratings-based approach for assessing capital, nor do they have a business model that would make the costs associated with developing a system for such an approach reasonable.

Safety and soundness of the banking system can be increased by providing incentives to a greater number of institutions to improve their risk management systems. This can be done by allowing U.S. banks and savings associations to adopt the standardized approach in the new accord that will be available in other countries. Also, the conditions for opting in to the more advanced internal ratings-based approach could be made less burdensome and the approach could be simplified to make it a more viable prospect for smaller institutions. Additionally, ACB has asked the U.S. regulators to address the ability of smaller institution to use third party vendors, consortiums, or other joint approaches in meeting the conditions for opting in to the new accord. It is likely that products and services will become available to assist institutions in obtaining the necessary data and establishing the necessary infrastructure to develop an internal ratings-based approach.

Conclusion

In conclusion, ACB does not oppose the implementation of Basel II in the United States. We believe, however, that more examination has to be given of 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. We thank Chairman Bachus 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.

Appendix A

RISK-BASED CAPITAL
PROPOSED FORMULA

<u>0% Risk Weight Category</u>

Cash on Hand
U.S. Treasuries
* **Interest-Earning Deposits (CD's) ≤ $100,000**

<u>20% Risk Weight Category</u>

Cash Items
Correspondent Banks
Fed Funds Sold
FHLB Stock
General Obligation Municipal Investments
Loans Secured By Deposits
Money Market Fund Investments
Municipal Loans
U.S. Agencies
U.S. Agency-Issued MBS's
* **Interest-Earning Deposits (CD's) > $100,000**
* **1-4 Family First Mortgages with LTV Ratio ≤ 60%**
* **HE Loans & HELOC's (including 1st Mtg) with LTV Ratio ≤ 60%**
* **Commercial Mortgages with LTV Ratio ≤ 20%**
* **Consumer Loans with LTV Ratio ≤ 25%**
* **Bank Land & Premises - 50% of Appraisal Value**

<u>40% Risk Weight Category</u>

* **1-4 Family First Mortgages with LTV Ratio > 60% and ≤ 75%**
* **HE Loans & HELOC's (including 1st Mtg) with LTV Ratio > 60% and ≤ 75%**
* **Commercial Mortgages with LTV Ratio ≤ 40%**

<u>50% Risk Weight Category</u>

Other Qualifying Junior Liens
Private-Issue MBS's
Qualifying Construction Loans
Revenue Bond Municipal Investments
* **1-4 Family First Mortgages with LTV Ratio > 75%**
* **HE Loans & HELOC's (including 1st Mtg) with LTV Ratio > 75%**
* **Commercial Mortgages with LTV Ratio ≤ 50%**
* **Consumer Loans with LTV Ratio > 25% and ≤ 60%**
* **Commercial Loans with LTV Ratio ≤ 40%**

<u>60% Risk Weight Category</u>

* **Commercial Mortgages with LTV Ratio ≤ 60%**

<u>80% Risk Weight Category</u>

* **Commercial Mortgages with LTV Ratio ≤ 80%**

<u>100% Risk Weight Category</u>

Allowance for Loan & Lease Losses
Corporate Bond Investments
Loans Past Due 90+ Days
All Other Assets
* **Commercial Mortgages with LTV Ratio > 80%**
* **Consumer Loans with LTV Ratio > 60%**
* **Commercial Loans with LTV Ratio > 40%**
* **Bank Land & Premises - 50% of Appraisal Value**
* **Unsecured Loans**

Off-Balance Sheet Items (20% Risk Weight)

Letters of Credit (Cash Collateral)
Letters of Credit (Other Collateral)

Total Adjusted Assets

Items notated with a * (and in bold type) "proposed".