

Testimony of
Independent Community Bankers of America
on
“The New Basel Accord—In Search of a Unified U.S. Position”
before the
Subcommittee on Financial Institutions
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Mr. Chairman, Ranking member Sanders, and members of the Committee, my name is Karen Thomas and I am Director of Regulatory Affairs and Senior Regulatory Counsel for the Independent Community Bankers of America ("ICBA")¹. I am pleased to appear today on behalf of the ICBA to discuss Basel II and its implications for community banks in the United States.

"Basel II" refers to the proposed new, highly complex regulatory capital accord under development by the Basel Committee on Banking Supervision. Basel II is proposed to replace the existing 1988 Accord (Basel I) with a more risk sensitive framework in order to improve safety and soundness in the financial system. The structure of the new accord is built around three pillars: minimum capital requirements, supervisory review process and market discipline/disclosure.

The Basel Committee's third consultative paper on the new accord was issued for public comment several weeks ago. The U.S. agencies plan to outline their preliminary proposals for how Basel II will be implemented in this country next month in an Advance Notice of Proposed Rulemaking.

In this regard, the ICBA applauds the U.S. regulators for their announced intention to limit the scope of application of Basel II in the U.S. and not to apply Basel II to non-complex community banks. In fact, U.S. regulators plan to require only the largest ten or twelve U.S. banks to comply with the Advanced Internal Ratings Based approach for credit risk and the Advanced Measurement Approach for operational risk. This group of banks is both large in scale and is engaged in significant international activities. After the first round of final Basel II rulemaking, the banking regulators expect that another ten or so of the largest banks that can meet the qualifying internal infrastructure standards for risk measurement and management will also elect to comply with Basel II, due to competitive or market pressures.

ICBA hopes that in the future U.S. banking regulators will continue to require only the largest, internationally active U.S. banks to apply Basel II and to exempt "second tier banks" and non-complex community banks. There are several reasons for recommending this. First, methods of assessing capital adequacy must be appropriate to the size and complexity of operations of the bank. Bank consolidation in the United States continues to move the industry towards a barbell shape with a few large, complex, globally active institutions on

¹ ICBA is the primary voice for the nation's community banks, representing some 4,600 institutions with 17,000 locations nationwide. Community banks are independently owned and operated and are characterized by attention to customer service, lower fees and small business, agricultural and consumer lending. ICBA's members hold more than \$526 billion in insured deposits, \$643 billion in assets and more than \$402 billion in loans for consumers, small businesses and farms. For more information visit www.icba.org.

one end, and thousands of smaller, non-complex, community-focused institutions on the other. In our view, capital adequacy regulations must recognize the increasing differences between these two ends of the spectrum.

Second, since an important objective of Basel II is cross-border competitive equality, it is not necessary to require smaller banks that do not compete in international markets to apply Basel II. Only a handful of the largest banks account for most of the international banking activities conducted by U.S. banks. Collectively, the regulators estimate that the 20 or so banking organizations that will comply with Basel II account for about 99 percent of the foreign assets held by the top fifty domestic U.S. banking organizations, and for approximately two-thirds of the domestic assets of U.S. banking organizations.

Third, on average community banks historically have tended to maintain higher capital ratios than larger institutions. Because of their smaller size, and limited access to capital markets, they have few alternatives for augmenting capital—particularly in times of stress—other than through retained earnings. For this reason and others, they generally maintain a strong capital position, in excess of regulatory minimums. According to the Federal Reserve, more than 93 percent of the banks that are outside of the top 20 banks have risk-weighted capital ratios in excess of 10 percent, which is 2 percentage points or 25 percent higher than the minimum 8 percent required by Basel I. For the 8,800 banks with less than \$1 billion in assets at year-end 2002, the numbers were particularly striking. Banks with less than \$100 million in assets had an aggregate risk-weighted capital ratio of 16.6 percent; and banks with assets of \$100 million to \$1 billion had an aggregate risk-weighted capital ratio of 13.8 percent, according to FDIC data. For banks with more than \$10 billion in assets, the figure was 9.14 percent.

Fourth, the goals of Pillar II (supervisory review) and Pillar III (disclosure) of Basel II have been effectively achieved in the U.S. The U.S. banking regulators already do a very effective job supervising banks and reviewing their capital positions. Furthermore, U.S. banks already disclose significant amounts of financial information, including their capital ratios, through their Call Reports and, if they are publicly held institutions, in their annual and quarterly reports.

Minimum Capital Requirements (Pillar I)

The proposed Basel II accord would make significant and far reaching changes to minimum capital requirements. Basel II would allow banks to use one of three approaches. The Foundation Internal Ratings Based approach and the Advanced Internal Ratings Based approach use sophisticated internal credit risk rating models and systems to measure capital adequacy (the IRB approach). The Standardized approach would substantially refine the current accord and incorporate external credit ratings and credit risk mitigation elements in the risk-weight framework.

The changes to the current capital adequacy framework contemplated in Basel II are unduly complex and costly and unnecessarily burdensome for U.S. community banks and could result in higher minimum capital requirements for these institutions even though there is no increase in their risk profiles. As ICBA told U.S. regulators and the Basel Committee in 2001, we believe that Basel II is overkill for non-complex community banks, and that the costs and burdens of adhering to Basel II would outweigh the benefits, if any, of moving to the new accord. Both the IRB approach and the Standardized approach make changes that are inapplicable and/or inappropriate for most community banks.

The IRB approach is appropriately applied only to a small number of large banks. This approach is simply infeasible for community banks, and will remain so in the future. Community banks do not have the resources to use sophisticated internal risk rating models—which are overly complex and too costly for their needs—that meet the accord’s requirements. A community bank is not likely to have a sufficient volume of credits to maintain a sophisticated, statistically valid model with the requisite degree or range of meaningful risk refinement to justify the high costs associated with the extensive data collection, record keeping, and maintenance of the model.

As for the Standardized approach, community bank credits consist mostly of retail credits—loans to consumers and small businesses, which will have a risk weight of 75 percent (versus 100 percent under Basel I). Loan secured by certain residential real estate will have a 35 percent risk weight (versus 50 percent under Basel I). Community banks generally do not lend to externally rated corporate entities and will have a smaller proportion of loans that qualify for lower capital charges under the credit risk mitigation provisions of Basel II.²

The Standardized approach—despite its additional complexity, risk buckets and incorporation of external risk ratings—may not materially affect a non-complex bank’s minimum capital requirements, when the additional charge for operational risk required under Basel II is taken into account. But, as with any change, the Standardized approach would present the burdens of learning and mastering a new scheme, changing systems and software, and retraining management, boards, and employees—with little corresponding benefit to justify the costs for community banks.

² The credit risk mitigation provisions of the Standardized approach will be of limited use to many community banks because the definition of eligible collateral is restricted mainly to financial asset collateral, such as cash, highly-rated securities and gold. As providers of retail credit, the most common form of collateral for community bank loans is physical collateral such as real estate, automobiles, equipment, inventory, livestock and crops. Community banks may have a small percentage of loans that are guaranteed by the U.S. government or an agency thereof, through special programs administered by the Small Business Administration, Federal Housing Administration, etc.

In light of the robust system of capital adequacy requirements already in place in this country, U.S. regulators rightly concluded that the costs of applying Basel II to the entire population of U.S. banks would greatly outweigh any benefits.

ICBA had expressed these views directly to the Basel Committee during a meeting the Committee held with representatives of small and medium-sized banks around the world in July 2001. At that meeting, U.S. regulators, with our full support, said they did not intend to apply the new accord to non-complex banks. They stressed that because of the distinct attributes and structure of the banking systems in various countries, each country's supervisors must have flexibility to determine the scope of application of the new accord in their own country. The U.S. diversified financial system, which includes thousands of smaller community banks, is unique.³

Competitive Concerns

Even though community banks are pleased with the decision regarding the scope of application of Basel II in the U.S., that does not mean that we do not have concerns about the impact Basel II will have on community banks. In particular, community banks are concerned that Basel II may place them at a competitive disadvantage as Basel II will yield lower capital charges for residential mortgage, retail, and small business loans.

Larger banks that have the resources and capability to apply Basel II will choose it over Basel I if they perceive it to be in their best interests to do so. Under the IRB approach, various types of credits will enjoy much lower risk-weights and correspondingly lower capital charges than under the Basel I accord. The Basel Committee intends the lower minimum capital requirements associated with the more sophisticated methods to provide an incentive for banks to adopt the costly, more advanced risk assessment and management techniques.

Thus, banks using the internal ratings-based approach can be expected to use Basel II to keep their capital levels very tight. This would result in community banks having relatively higher minimum capital thresholds, which could put them at a potential competitive disadvantage.

A review of the Basel Committee's Quantitative Impact Study 3 (QIS3) heightens our concern. Analyzing Basel II's impact on more than 300 individual banks, QIS3 compares the average risk weights and capital charges for various

³ At year-end 2002, there were 9,354 FDIC-insured institutions in the U.S. Approximately 8,800 had assets of less than \$1 billion (4,700 with assets of less than \$100 million); 550 had assets of more than \$1 billion (106 with assets greater than \$10 billion).

credit portfolios required by the current Basel I accord with those required under Basel II. Average risk weights and capital charges for some types of credit and asset portfolios would increase. But for retail credits, including mortgage and non-mortgage loans to individuals and small businesses—the very credits where community banks compete with large banks—the risk weights and capital charges would significantly decrease. For example, total retail credit capital charges under the Advanced IRB approach are estimated to decrease by 50 percent (60 percent for mortgages, and 41 percent for non-mortgages) among the banks in the G10 market area.

There is a cost to a bank for maintaining capital, and regulatory capital is a key factor in profitability and return on equity. The lower capital requirements may result in a cost advantage, and correspondingly a pricing advantage, in retail credits for large banks that are subject to Basel II.

One key factor is whether a bank's overall capital requirements, and not capital allocated for individual portfolios, will govern pricing decisions. Once operational risk charges are added to regulatory minimums, the overall change in minimum required capital may be relatively small. The QIS3 result was an aggregate 2 percent reduction overall using the Advanced IRB approach, although the experience of individual banks will vary widely. Particularly for a bank with a large percentage of its portfolio in low-risk weight retail credits, its overall minimum capital requirements will drop significantly, perhaps as much as 30 percent by some estimates. In addition, in the U.S., the "prompt corrective action" requirement to maintain a leverage capital ratio of 5 percent in order to be considered "well-capitalized" may act as a floor on how low regulatory minimums can go.

ICBA urges U.S. regulators to examine the question of competitive impact closely, and carefully review the expected practices of Basel II banks, as they consider implementation of Basel II. Because of the important role small and medium-sized institutions play in the economy by providing credit to consumers and small and medium-sized businesses, it is imperative to consider the competitive impact Basel II will have on second tier and community banks, and their customers.

If competitive inequities can be expected between Basel I and Basel II banks, a suitable response should be to consider whether some adjustments for Basel I banks, such as additional risk buckets to increase risk sensitivity and help balance the inequities, are appropriate. In addition, regulators should consider whether to allow second tier banks and community banks to opt to apply the Basel II Standardized approach in order to avail themselves of its lower risk weights for retail credits.

Challenges for Regulators in Applying Basel II

Regulators must be mindful of the conflict of interest inherent in using internal capital allocation models to both optimize profitability and increase returns on the one hand, and determine adequate capital levels on the other. Institutions using the IRB approach will have incentive to understate risk and losses in order to reduce capital requirements and increase return on equity. To guard against this, methods of ensuring accountability on the part of institutions using the IRB approach must be part of Basel II.

Under the IRB capital scheme, regulators will ultimately be responsible for ensuring institutions maintain adequate capital levels and must be very careful to assure the suitability and validity of IRB models, which may prove to be a daunting task. Only those institutions that are truly qualified to use the IRB approach should be permitted to do so. Mistakes or faulty judgments will have far reaching implications as regulators face the challenges of supervising large, complex banking organizations whose failure or disruption of operations present systemic risk to the domestic and global financial system and economy.

Conclusion

Methods of assessing capital adequacy should be appropriate to the size and complexity of operations of the bank. In this regard, ICBA strongly supports the intention of U.S. bank regulators not to require application of the Basel II capital accord to “second tier” and community banks in the U.S. Basel II is unduly complex and unnecessarily burdensome for U.S. community banks. The Basel I accord has worked well and generally remains well suited to assess capital adequacy for these banks.

At the same time, the ICBA is concerned that the Basel II changes and lower minimum capital requirements will result in a competitive and pricing disadvantage for Basel I banks, particularly with respect to residential mortgage, retail, and small business loans. We urge careful examination of this issue and its implications not only for Basel I banks, but for their customers as well. To address any competitive inequities, regulators should consider appropriate adjustments for Basel I banks, such as additional risk buckets or changes in risk weights to increase risk sensitivity.

Thank you for the opportunity to provide ICBA's views on this important subject. At the appropriate time, I will be glad to answer any questions you or members of the Committee may have.