Testimony
by
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on behalf of

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Washington, DC

"A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate"

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Committee on Financial Services;
Subcommittee on Financial Institutions
and Consumer Credit

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Mr. Chairman, ranking member Maloney, and members of the subcommittee, my name is James H. McKillop, III. I am President and CEO of the Independent Bankers' Bank of Florida. I am also a member of the Federal Legislation Committee of the Independent Community Bankers of America[1]. ICBA welcomes the opportunity to testify on the bank regulatory agencies' proposed guidance on commercial real estate lending and on the agencies' proposed rulemaking to implement the Basel II rules. This statement will first address the CRE lending guidance and then turn to the Basel II rulemaking.

I want to compliment this subcommittee for taking up these difficult regulatory issues late in the Congressional session. These proposals deeply affect community banks and their ability to serve their communities. Your continued oversight is very important.

Let me tell you something about me and the Independent Bankers' Bank (IBB). I am a 6th generation Floridian; my family started there in the title business. The business of my bank is concentrated in commercial real estate lending. We have CRE loans equal to 600% of capital, 7 1/2 percent Tier 1 capital and a $3 million dollar allowance for losses.

The IBB serves the loan, operational, and investment services needs of over 270 community banks throughout Florida, and the southern portions of Georgia and Alabama. Of those customers, 135 own shares in the Bankers' Bank. As a bankers' bank, we offer services only to community banks, not to the general public. This unique focus on community banks has given me an opportunity to hear and address the business challenges faced by community banks throughout the region that we serve. We are headquartered in Lake Mary, Florida. As of June 2006, IBB's total assets were nearly $435 million and we administered over $2.0 billion in total resources.

Commercial Real Estate

The Office of the Comptroller of the Currency, Board of the Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of Thrift Supervision have propose regulatory guidance entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.* The proposed guidance would require banks with concentrations in commercial real estate[2] lending (CRE) to tighten risk management practices and potentially

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[1] The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace. For more information, visit ICBA's website at www.icba.org.

[2] The proposed guidance defines CRE loans as exposures secured by raw land, land development and construction (including 1-4 family residential construction), multi-family property and non-farm nonresidential property where the primary or significant source of the repayment is

increase capital. The proposal contains thresholds for determining whether or not an institution has a CRE concentration. According to the proposed thresholds, many community banks would be considered to have a concentration in CRE lending.

Summary of ICBA Views on CRE Guidance

ICBA is gravely concerned that the proposed guidance is seriously flawed and we have strongly urged the banking agencies not to go forward with it in its current form. ICBA has received many communications from bankers about the proposed guidance and they are overwhelmingly negative. The regulators have received over 1,000 letters, many raising concerns about the proposal.

Community bankers view the proposal as overly broad, defining concentrations of risk in a manner that can not assess the true risk in a bank's CRE lending. Bankers are greatly concerned that they will need to rein in their CRE lending, if the guidance goes forward in its current form, though they do not believe that the risk in their portfolio warrants it. If they must decrease their CRE exposure, they will decrease their ability to meet the lending needs of their growing, thriving communities. Banks will suffer financially and so will their communities.

Community banks question the need for this new guidance; they believe that the existing body of real estate lending standards, regulations and guidelines is sufficient to guide banks through any weakness in the CRE market. Examiners already have the necessary tools to enforce rules and regulations and address unsafe and unsound practices; thus community banks view the new guidance as unnecessary. They particularly object to the proposed concentration thresholds as they believe the thresholds can give a misleading picture of risk exposure.

Banking regulators have stated that they have identified problems in "some" banks, yet they would apply this guidance in a broad brush approach across the entire industry, assuming many banks have problems. Instead, we believe that examiners should identify and address CRE lending and risk management problems, bank by bank.

While community banks are already employing many of the recommended risk management principles, they view the recommendations regarding stress testing and management information system improvements as costly, burdensome and unnecessary for banks that already closely monitor their loans and customers.

For these reasons, ICBA has strongly urged the banking regulators not to go forward with this flawed guidance as it was proposed.

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derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risk in CRE markets would also be considered CRE loans for purposes of the guidance.

Background on CRE Proposal
When issuing the proposal, the banking agencies stated they had observed that some institutions have high and increasing concentrations of commercial real estate loans on their balance sheets, potentially making them more vulnerable to cyclical commercial real estate markets. The regulators were particularly concerned about concentrations in CRE loans where the source of repayment is primarily dependent on rental income or the proceeds of the sale, refinancing or permanent financing of the property. These loans may expose institutions to unanticipated earnings and capital volatility due to adverse changes in the general commercial real estate market, the agencies state. The banking regulators have said that examinations have indicated that risk management practices and capital levels of some institutions are not keeping pace with their increasing CRE concentrations.

The proposal is intended to reinforce existing guidance relating to institutions with CRE concentrations. The banking regulators state that this guidance is intended to focus on concentrations in CRE that are particularly vulnerable to cyclical commercial real estate markets.

Many community banks are likely to be effected by the proposal. The FDIC estimated CRE loans constitute 258% of capital of the 8,235 banks with less than $1 billion in assets. Many of these banks have relied on commercial real estate lending for growth and profitability and may not have as diverse a portfolio as banks with assets greater than $1 billion due to the more limited markets they serve. CRE lending has made up at least two-thirds of asset growth at community banks each year since 2001; a record 28% of total community bank assets were in CRE loans as of March 2005.

ICBA Views on CRE Guidance
Community bankers recognize that they should prepare for any significant downturns in the CRE market; they are very concerned that the proposed guidance will unnecessarily constrain their ability to meet the needs of their commercial real estate customers. **Many community banks view the proposal as a call to cut back on CRE lending. If a community bank must cut back, it means cutting back on one of its more profitable business lines. But it also means less money will be available to support community growth.** This is a particular concern to community banks serving smaller communities and communities that have seen an influx of new businesses and residents. Community banks have told ICBA that they can and do manage their CRE portfolios in a safe and sound manner.

ICBA has urged the regulators to abandon the proposed concentration thresholds and look at an institution's credit risk and risk management practices on a case by case basis. **ICBA believes that the proposed threshold tests to determine whether or not an institution has a concentration in commercial real estate loans are seriously flawed and do not give a clear picture of risk.** They do not take into account the lending and risk management practices of individual institutions. They do not recognize that different segments of the CRE

markets have different levels of risk. Many community banks that exceed the threshold tests point out that they have gone through the difficult credit cycles in the 1980s and 1990s with less capital than they have now. They have learned from past mistakes and have more capital and stronger risk management systems than in the past and are now better equipped to handle future downturns.

Community banks underwrite and manage CRE loans in a conservative manner, requiring higher down payments or take other steps to offset credit risks and concentrations. They carefully inspect collateral and monitor loan performance and the borrower's financial condition. Community bankers lend in their communities and are close to their customers. Community banks believe they do a better job monitoring these loans than do large nationwide lenders because they are more likely to work one-on-one with the customer. They are positioned well to know the condition of their local economy and their borrowers.

While many community banks already have capital in excess of current minimum standards, they are concerned that the proposal calls for even higher levels simply because their CRE lending exceeds the proposed thresholds without any analysis of the actual risk. The proposed guidance is unfairly burdensome for community banks that do not have opportunities to raise capital or diversify their portfolio to the extent that larger regional banks can. The CRE portfolios of many community banks have grown in response to the needs of their communities. If community banks are pressured to lower their CRE exposures, their ability to generate income and more capital will be constrained and they will loose good loans to larger competitors.

The proposal's recommendations regarding management information system reports will be particularly costly and burdensome to community banks; the costs will most likely out weigh the benefits for smaller banks. They find the guidance regarding stress testing of the portfolio and changes to the management information systems called for by the guidance to be particularly burdensome.

ICBA is also concerned that market analysts will misapply the guidance when analyzing banks, using the thresholds to treat all CRE loans as having equal risk without taking into account the quality of underwriting standards and risk management practices or risk levels of individual loans when making buy, sell or hold recommendations. Thus the public will be misled about the true risk in a bank's portfolio.

Comments on Aspects of the Proposal

Thresholds for Assessing "Concentration"

In proposing the guidance, the banking agencies focused on concentrations in those types of CRE loans that are particularly vulnerable to cyclical commercial real estate markets. These include CRE exposures where the source of repayment primarily depends upon rental income or the sale, refinancing, or

permanent financing of the property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risk in CRE markets would also be considered CRE loans for purposes of the proposed guidance.

The banking regulators propose thresholds for assessing whether an institution has a CRE concentration and should employ heightened risk management practices. According to the proposal, if an institution exceeds or is rapidly approaching the following thresholds, it has a concentration in CRE loans:

1. Total reported loans for construction, land development, and other land[3] representing 100% or more of total capital;[4]

   OR

2. Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land[5] represent 300% or more of total capital.

If the bank exceeds threshold (1), it should have heightened risk management practices appropriate to the degree of CRE concentration. If the bank exceeds threshold (2), it should further analyze its loans and quantify the dollar amount of those that meet the definition of a CRE loan. If the institution has a level of CRE loans meeting the CRE definition of 300 percent or more of total capital, it should have heightened risk management practices described in the guidance. The guidance may also be applied on a case-by-case basis to any bank that has had a sharp increase in CRE lending over a short period of time or has a significant concentration in CRE loans secured by a particular property type.

Owner occupied loans are excluded from this guidance because their risk profiles are less influenced by fluctuations in the market. ICBA agrees that owner occupied loans should be excluded from the calculations as they pose less risk, but we also believe that loans made for the construction of 1-4 family homes should be excluded since they will be owner-occupied, and thus less influenced by market fluctuations. We also urged the banking agencies to clarify the meaning of "owner-occupied" since it is not currently defined and is unclear, such as when a loan is for a mixed use property when only a portion is owner occupied. In our view when an owner occupies at least a portion of the building, the risk profile is lowered.

[3] For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C item 1a. For Savings associations as reported in the Thrift Financial Report, schedule SC lines SC230, SC235, SC240, and SC265.
[4] Total capital is the total risk-based capital as reported in Call Report (FFIEC 031 and 041 schedule RC-R-Regulatory Capital, line 21). For savings associations as reported in the Thrift Financial Report, CCR, Line CCR39.
[5] For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C items 1a, 1d, and 1e. For savings associations as reported in the Thrift Financial Report Schedule SC lines SC230, SC235, SC240, SC256, SC260 and SC265.

While the use of such thresholds could facilitate the monitoring of a particular bank's level of CRE lending and the level of CRE lending in the industry overall, we do not believe that their use will give a reliable picture of the true level of risk in a particular institution or the industry. **The proposed thresholds can not capture true risk because they can not take into account underwriting standards and risk management practices. The thresholds treat all loans within the calculation as having equal risk.** For example, the second threshold test assumes loans secured by multifamily properties to have the same risk as land development loans, yet multifamily properties have historically preformed far better.

Further, the proposed thresholds can not truly identify a concentration. For example, a community bank with $100 million in assets with $80 million in loans and 8 percent capital could reach the first threshold with just $8 million in loans and the second threshold with $24 million in loans. This would represent only 10 percent and 30 percent of the entire portfolio, respectively, and does not truly imply a concentration.

Banking is about making judgments and managing risk. **We are concerned that the proposal would inappropriately replace judgments with "pass/fail" tests. Community banks are concerned that the proposed thresholds will be arbitrarily used by examiners to assess risk: exceed them and the bank is automatically a high risk institution and should raise more capital, without sufficient regard to risk mitigating factors.**

Each institution, its community, and thus its business, is different. Banking regulators send examination teams on site because that is the best way to ensure that they have a true picture of an institution's financial condition and risk management. We do not think arbitrary thresholds can replace this close up perspective.

Application of Guidance By Market Analysts

ICBA has been greatly concerned that market analysts would apply the proposed guidance as they analyzed the financial conditions of banks. In June, ICBA wrote to the banking regulators about an article published on RealMoney and republished on The Steet.com (attached) that raised a very serious concern about the guidance. In it, the author Richard Suttmeier, president of Global Market Consultants, Ltd. and chief market strategist for Joseph Stevens & Co, applied the proposed concentration thresholds to the six largest banks in the country and recommends adding to or reducing positions in their stocks, based only on price targets and on their percentage of CRE loans to capital. For example, he recommended that investors buy Bank of America stock because its ratio is "29%, below the FDIC 100% threshold" whereas he recommends immediately reducing holdings of BB&T Bank because its CRE loans are "way above the FDIC's red line at 197%" for one threshold and "above danger levels at 364%" for the second threshold.

Clearly, this analyst saw the proposed concentration thresholds as absolute cutoff levels, stating that when a bank's commercial development loans exceed 100% of capital, "it's a warning." When CRE loans exceed 300%, "it's a danger sign." The banking regulators stated that the proposed guidance is intended to reinforce existing guidance for institutions with CRE concentrations and indicate when they need to tighten risk management practices and potentially increase capital. **Yet, the proposed thresholds of concentrations are being treated by this analyst as new buy/sell indicators for investment transactions, regardless of other business or financial indicators for a financial institution. We are extremely troubled by the application of the proposed guidance in this manner.**

Risk Management Principles

The agencies proposed several risk management principles to reinforce a safe and sound real estate lending program.

Board Oversight

The proposal points out that the board of directors has the ultimate responsibility for the level of risk taken by the institution. Therefore, the board or a board committee should approve the overall CRE lending strategy and policies and receive reports on the CRE market and lending activities. The board should periodically review and approve CRE aggregate risk exposure limits and appropriate sublimits to correspond with changes in strategies or market conditions. The board should also ensure that management compensation policies are compatible with the institution's strategy and do not create incentives to assume unintended risks. **This is the approach already in place in community banks.**

Strategic Plans

The bank must include the rationale for its CRE levels in its strategic plan, analyze the effect of a downturn on earnings and capital, and have a contingency plan. The agencies require that each bank adopt and maintain a separate written policy that establishes appropriate limits and standards for all loans secured by real estate. Loans exceeding the interagency loan-to-value (LTV) guidelines should be recorded and reported to the Board. Examiners will review these reports to determine if they are adequately documented. **Community banks have told ICBA that they do not view this as a change from their current practices.**

Secondary Market Underwriting

According to the proposal, when a bank's underwriting standards are substantially more lenient than the secondary market standards, management should justify the reasons why the risk criteria deviate from those of the secondary market. Community banks have great difficulty in underwriting their CRE loans to secondary market standards. For many of the CRE loans that community banks make, there isn't a ready secondary market—certainly not like that which exists for residential mortgages. Many of the loans are for projects that are too small or that have characteristics that make them unsuitable for

securitization. Many community banks still hold residential mortgages in portfolio because they do not meet secondary market underwriting standards, but that does not make them inherently riskier. In our view, the same can be said for CRE loans. **Thus, this portion of the guidance is not practical for community banks and many of the CRE loans they make.**

The regulators also suggest that banks use secondary market sales or securitizations to manage concentration levels. This is not a realistic option for many community banks. While they may be considered to have a concentration of CRE loans, due to their size, it does not equate to a large volume of loans. Secondary markets and securitizations depend on volume and community banks often are frustrated because they do not have sufficient volume for these to be viable options.

Risk Assessment

According to the proposal, banks must measure and control commercial real estate risk at the portfolio level by identifying and managing concentrations, performing market analysis, and stress testing. The proposed guidance states that a bank's management information system (MIS) should provide meaningful information on CRE portfolio characteristics that are relevant to the institution's lending strategy, underwriting standards and risk tolerances. Banks are encouraged to analyze the portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating. The system should maintain the appraised value at origination and subsequent valuations. Other measurements should include loan structure, loan type, loan-to-value limits, debt service coverage, and policy exemptions.

Banks are encouraged to stress test the CRE portfolio against changing economic conditions. The agencies state they realize stress testing is an evolving process and encourage banks to consider its use as a risk management tool and to periodically review the adequacy of stress testing practices relative to CRE risk exposures. The complexity of a bank's stress testing practices should be consistent with the size and complexity of its CRE loan portfolio.

Community banks believe that the proposal's recommendations regarding MIS enhancements and stress testing are particularly costly and burdensome to community banks; the costs will most likely out weigh the benefits for smaller banks, with the result being an unwarranted and unnecessary contraction in CRE lending. While by the proposed thresholds a community bank may be deemed to have a concentration in CRE loans, it may not equate to a large number of loans due to the bank's size. Community banks typically operate in a limited geographic area, enabling them to closely monitor the economic status of individual borrowers, the industry and the community. **Thus, we do not believe that the regulators should put out a general call for increased MIS systems and stress testing. Rather they should look at the particular needs of an institution during the examination process and urge enhancements when they find that existing systems and are lacking.**

Capital Adequacy

The proposal states that minimum levels of regulatory capital do not provide banks with a sufficient buffer to absorb unexpected losses arising from loan concentrations. A bank with a CRE concentration should recognize the need for additional capital support for CRE concentrations in its strategic, financial, and capital planning, including an assessment of the potential for future losses on CRE exposures, the guidance says. Institutions with high or inordinate risk are expected to operate well above minimum capital requirements. In assessing capital adequacy, regulators will consider the bank's analysis, the level of risk in the portfolio and the quality of the bank's risk management practices.

Most community banks already hold capital levels well above regulatory minimums and are concerned that the proposed guidance could require them to hold even more. **We question whether the proposed guidance regarding capital levels is consistent with risk based capital requirements currently in place that assess capital adequacy based on risk inherent to an asset class and consistent with existing regulatory requirements that tie capital requirements to loan-to-value ratios.**

ICBA has urged the banking regulators to not arbitrarily require banks to hold more capital (or require them to decrease CRE lending) simply because they pass certain thresholds of CRE loans to capital. Community banks believe the suggestion that they would need more capital if they are identified as having a CRE concentration does not recognize the fact that risk-based capital standards can and should address risk based on asset risk. Guidance pertaining to capital should be consistent with existing capital rules and guidance.

The allowance for loan losses is another means of protecting an institution that should be a consideration in determining the effects of potential concentrations on capital adequacy. However, banks should not be required by their regulators to increase their reserves based on arbitrary tests for the amount of CRE loans, a measure that may or may not be a true indicator of loan losses.

Hurricane and Other Disaster Areas

The proposed guidance is particularly troublesome for community banks located in areas affected by Hurricanes Katrina and Rita and other disaster areas where rebuilding efforts are very likely to cause them to have CRE concentrations. We have urged the regulators that should they go forward with this guidance, to either exempt community banks operating in these locations from the guidance or provide them maximum flexibility to continue their support of rebuilding efforts.

Summary and Recommendations on CRE Guidance

ICBA strongly urged the banking regulators not to go forward with the guidance as proposed. Regulators should instead rely on existing rules, regulations and guides for management of risks in CRE lending to ensure banks take appropriate steps to protect their safety and soundness when they are experiencing high levels of lending growth, particularly in industries such as CRE where history demonstrates that significant downturns can occur.

Community banks object strongly to the proposed thresholds for determining CRE concentrations as they do not believe that they are reliable measures of the true risk in an institution. Community banks have taken significant steps since previous CRE downturns; they underwrite loans conservatively, have better staff resources and higher capital and thus are in a better position to withstand weakness. Because they lend in limited geographic areas and typically have a close customer relationship, they are in a good position to closely monitor their CRE loans and economic factors impacting them.

The banking regulators should address problems on an individual bank basis, rather than issue broad "one size fits all" guidance that may cause community banks to curtail their CRE lending when it is not necessary for safety and soundness. If a broad message is sent across the banking industry that absolute levels of CRE lending are inherently unsafe and unsound, banks will respond and cut back on CRE lending, which will unnecessarily curtail their earnings ability and the growth of their communities.

We urged the regulators not to go forward with the guidance as proposed and instead send a clear message to banks and their examiners that growth in CRE lending can occur, consistent with safety and soundness, when banks take the steps to manage it properly.

Basel II and Basel IA

This subcommittee has played a key oversight role in the development of the United States' position on Basel II. Legislation members introduced last year, the United States Financial Policy Committee For Fair Capital Standards Act (H.R. 1226), clearly signaled that you expected the views of every agency and type of institution considered in this process.

Last week, the banking agencies issued for comment a notice of proposed rulemaking (Basel II NPR) that would implement new risk-based capital standards in the United States for large, internationally active banking organizations. The proposed Basel II rules would require some and permit other banks to use an internal ratings-based approach (IRB) to calculate regulatory credit risk capital requirements and advanced measurement approaches (AMA) to calculate regulatory operational risk capital requirements. Banks with consolidated total assets of $250 billion or more or with consolidated total on-balance sheet foreign exposure of $10 billion or more would be subject to the proposed Basel II rules. Other banks would have the opportunity to opt-in to the new capital standards provided they receive the approval of their primary federal supervisor.

Summary of ICBA's Position on Basel II and IA

- Although ICBA commends the banking agencies for their decision to retain the leverage capital ratio as part of Basel II and to include other safeguards during the transition period, ICBA remains concerned that Basel II may place community banks at a competitive disadvantage.

- ICBA is also concerned about the costs and complexity of Basel II and the ability of Basel II adopters to understand and implement the new accord. ICBA supports allowing the Basel II banks the option of using the "standardized approach" in lieu of the advanced approach.

- ICBA fully supports the current effort by the regulators to revise Basel I to enhance its risk-sensitivity and to address any competitive issues with a bifurcated framework; provided that the new rules give highly capitalized community banks the option to continue using the existing risk-based capital rules**.**

- During 2008—the year of the parallel run (when both Basel I and II capital will be calculated)--ICBA strongly recommends that the agencies conduct a fifth quantitative impact study to determine the impact that a revised Basel I would have on minimum risk-based capital and whether the competitive disparities between the Basel I and Basel II accords would be mitigated by a Basel IA. If QIS5 indicates that there continues to be a competitive disparity between Basel II and Basel IA, then the three year transition period should be put on hold until the regulators fundamentally revise Basel II.

ICBA Strongly Supports Retention of the Leverage Capital Ratio
As proposed by the agencies last week, the Basel II banks will remain subject to the tier 1 leverage ratio (e.g., tier 1 capital to total assets) and the prompt corrective action regulations mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). **ICBA commends the banking agencies for proposing to retain the tier 1 leverage ratio as part of the Basel II. ICBA strongly believes that retention of the leverage ratio is essential to maintaining the safety and soundness of our banking system and is a needed complement to the risk-sensitive Basel II framework that is based only on internal bank inputs.** Capital requirements under Basel II depend heavily on the answers to questions that vary from bank to bank and have no objectively best answer. No matter how refined a risk-based capital framework the regulators come up with, there will always be a need for straightforward capital minimums.

Furthermore, 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 the FDIC's Deposit Insurance Fund and our economy would be enormous. As then

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."[6]

ICBA Supports the Transitional Capital Floors

Beginning in 2008, the Basel II banks will be able to conduct a parallel run--calculating their capital using both the present risk-based capital rules of Basel I and the advanced approaches of Basel II. During a three-year transition period from 2009 to 2011, Basel II banks would be subject to "transitional floors" that would limit the reduction of their minimum risk-based capital requirement in any year to 5%. **ICBA commends the banking agencies for proposing to adopt these transitional floors as well as committing to significantly modifying the supervisory risk functions of Basel II if, during the three-year transition period, there is a ten percent or greater decline in aggregate minimum risk-based capital of Basel II banks as compared to minimum required risk-based capital as determined under the existing Basel I rules.** We believe that any change 10% or greater would warrant a fundamental change to the Basel II rules.

ICBA Remains Concerned about the Competitive Inequities

Despite the safeguards incorporated into Basel II mentioned above and the efforts by the regulators to revise Basel I, ICBA remains concerned that Basel II may place community banks at a competitive disadvantage. The IRB approach of Basel II will 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 both the third and fourth Quantitative Impact Studies (QIS3 and QIS4) have confirmed our concerns about the competitive equities of the new accord. These studies show dramatic reductions in capital for residential mortgage credits, small business credits and consumer credit. For instance, QIS4 indicates that for the Basel II banks, there would be a 79% median percentage drop in minimum required capital for home equity loans, a 73% drop for residential mortgage loans, and a 27% drop for small business loans. For all credits, risk-based capital requirements would decline by more than 26%. If one considers that the current minimum capital requirement under Basel I for mortgage loans is 4%, an average drop of 79% would mean that minimum capital

[6] Testimony before the Senate Banking Committee (April 20, 2004)

requirements for the Basel II banks would be less than 1% 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 smaller banks by larger banks seeking to lever capital efficiencies. As more of the larger banks opt-in over the long-term, this may eventually threaten the viability of community banking. 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.

A paper released last year by J.P. Morgan Securities Ltd London entitled "Basel II—And the Big Shall Get Bigger" concludes that if Basel II were to be adopted in its present form, the Basel II banks would have a "decisive competitive advantage" over other banks and will look to expand and arbitrage their capital by purchasing smaller, less sophisticated banks. As for the effect of Basel II on community banks, J.P. Morgan says:

> It is difficult to see the future for the smaller community banks in this 'brave, new world'. This has not gone unnoticed as the S&P notes "U.S. community bankers are up in arms against Basel II, saying it gives an unfair advantage in leverage and pricing to large internationally active competitors over smaller domestic banking groups". This seems to be backed up by available information, from which it would appear that the large US and European banks are much more advanced in terms of implementing Basel II as well as likely to be big new beneficiaries of the process. We believe the best opportunities for smaller banks to combat this is perhaps through more cooperation with each other, to share data, bear costs and even swap assets. An alternative seems to be buying the risks that the bigger players do not want, which may mean the potential of adverse selection in credit risks. In our opinion, this is not a recipe for long-term success."

Community banks play not only a strong role in consumer financing in this country but also a critical 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 small business customers.**

Basel II is Too Complex and Costly

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. The wide diversity in the results from QIS4 suggests that Basel II is too complex and that banks will have difficulty in applying the new accord consistently. Capital requirements in Basel II are very sensitive to inputs. Achieving consistency in Basel II depends on the idea that every bank will eventually adopt a common method for estimating their risk inputs leading to a convergence in the capital treatment of similar loan portfolios across banks. However, at least as indicated by the results of QIS4, there seems to be little commonality in the approaches that various banks used to estimate their risk inputs.

ICBA is also concerned about the high compliance and supervisory costs of Basel II. For example, nineteen of the twenty-six banks that participated in QIS4 indicated that it would cost $791 million over the next several years to implement the new accord. This estimate did not include the implicit costs of Basel II—the increased time and attention required of bank management to introduce and monitor the new programs and procedures. The OCC has estimated that its total 2005 costs for Basel II amounted to $7.1 million. Assuming that supervisory costs will increase during the Basel II transition period and that the other three banking agencies will incur comparable costs, it is easy to see that total supervisory and compliance costs for Basel II during the transition period will exceed $1 billion.

ICBA has recommended that the bank regulators consider ways of simplifying Basel II to reduce total compliance and supervisory costs and to insure that banks will understand the formulas and apply them consistently. The new accord and its capital formulas should not be so complex that banks cannot consistently apply the formulas and come to similar conclusions. Regulators should be able to 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.

To reduce the costs and complexity of Basel II and enhance its flexibility, ICBA supports allowing the Basel II banks the option of using the "standardized approach" of the new accord in lieu of the advanced IRB approach. The standardized approach would provide a simpler and cheaper alternative for measuring credit risks and would be attractive option for smaller, less complex Basel II banks. The standardized approach would require fixed risk-weights to be applied to different assets much like Basel IA and would align risk weights with a borrower's creditworthiness as indicated by the borrower's external credit rating. Unlike Basel IA, banks using the standardized approach would have to assess operational risks. ICBA believes that the use of the standardized approach by the Basel II banks would reduce the impact on risk-based capital by those banks and would mitigate to some extent, the competitive disparity between Basel I and II.

ICBA Fully Supports a Basel IA

ICBA fully supports the current effort by the regulators to revise Basel I to enhance its risk-sensitivity for non-Basel II banks and to address any competitive issues with a bifurcated framework; provided that the new rules give highly capitalized community banks the option to continue using the existing risk-based capital rules. ICBA commends the issuance late last year of an Advance Notice of Proposed Rulemaking concerning a revised Basel I (ANPR) and looks forward to commenting on a notice of proposed rulemaking regarding a revised Basel I which is expected to be issued in the next few weeks.

ICBA supported the ANPR's proposal to add risk categories to Basel I to enhance its risk-sensitivity and to align capital requirements with risk levels. The risk-weightings of these categories should be modernized to better match current knowledge about actual risk exposures. More specifically, ICBA supported the proposal in the ANPR to add additional risk weights (e.g., a 20 percent and 35 percent category) for assessing a bank's one-to-four family mortgage portfolio and to base those risk weights on loan-to-value ratios. If risk-weights are based on LTV ratios, we would recommend that a mortgage loan LTV ratio be determined at the time the mortgage is originated and that banking institutions have the flexibility of changing or updating the risk weights of their mortgage loans as normal principal payments are made and/or as the LTV ratios change. While we acknowledge that pairing credit scores with LTV ratios might enhance the risk sensitivity of the mortgage loan risk weight categories, we believe the regulatory burden of including credit scores with LTV ratios outweigh the benefits.

For small business loans, ICBA recommends that the agencies establish a 75 percent risk weight category for small business loans that are under $2 million and that are (1) fully collateralized, (2) amortizable over a period of 10 years or less, and (3) have been originated consistent with the banking organization's underwriting policies. ICBA also agrees with the concept of using external credit ratings to enhance the risk-sensitivity of Basel I and supports the use of different risk weight categories for categorizing rated investment securities. ICBA agrees with the agencies that the current zero percent risk weight for short- and long-

term U.S. government and agency exposures that are backed by the full faith and credit of the U.S. government should be retained as well as the 20 percent risk weight for U.S. government-sponsored entities and for general obligation municipal securities.

ICBA Strongly Supports a Basel IA Opt-Out Provision for Community Banks

ICBA has urged the regulators to adopt an "opt-out provision" as part of a revised Basel I that would give highly capitalized community banks the option to continue using the existing risk-based capital rules and avoid the regulatory burden of more complex risk-based capital rules. Many community banks have excess capital and would prefer to remain under the existing risk-based capital framework without revision to avoid unnecessary regulatory burden. This is particularly true for smaller banks that are management-owned, otherwise closely held, or not publicly traded, or banks in rural or other smaller markets. These banks generally hold higher amounts of capital than regulatory minimums—many significantly higher—for a variety of reasons including a conservative philosophy or lack of ready access to raise capital in the capital markets. For instance, the average total risk-based capital ratio for banks under $100 million in assets is 19.7% and for banks between $100 million and $1 billion is 14.55% according the FDIC's latest Quarterly Bank Profile.

For highly capitalized banks, computing risk-based capital minimums and ratios using the contemplated Basel IA could present a significant regulatory burden with no corresponding benefit. This is particularly true since the agencies expect that if Basel IA is adopted, changes in reported Call Report data will be necessary in order to capture the additional information for LTV ratios and other risk driver data points such as collateral, loan size, term to maturity, etc. We recommend that the opt-out provision be limited to community banks with under $5 billion in assets that have capital-to-asset leverage ratios of 7 percent or higher.

ICBA Recommends a QIS5

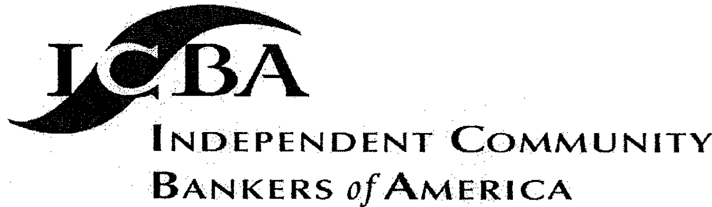
During 2008—the year of the parallel run--ICBA also strongly recommends that the agencies conduct a fifth quantitative impact study to determine the impact that a revised Basel I would have on minimum risk-based capital and whether the competitive disparities between the Basel I and Basel II accords would be mitigated by a Basel IA. We believe that a one-year period should provide sufficient time for the agencies to collect the data, compare the two accords, and determine the competitive effects. If, by the end of 2008, the results of QIS5 indicate that there continues to be a competitive disparity between Basel IA and Basel II, then the three-year transition period should be put on hold until the regulators determine how to fundamentally revise Basel II.

Conclusion

The ICBA again appreciates the opportunity to present our views on the proposed commercial real estate guidance and proposed international capital standards. We believe that the CRE guidance is seriously flawed and could undermine community banks' ability to serve their growing communities. Rather than imposing a one-size-fits-all approach, the agencies should use existing policies and procedures to ensure that, on a bank-by-bank basis, risks from all types of lending – including commercial real estate – remains at acceptable levels.

ICBA remains concerned that Basel II may place community banks at a competitive disadvantage. Improvements to Basel I, a Basel IA, could help mitigate that disadvantage. As it implements these proposals, the agencies should conduct a fifth quantitative impact statement to measure their effect on competition and on minimum risk-based capital levels. If, by the end of 2008, the results of a fifth quantitative impact statement indicate that there continues to be a competitive disparity between Basel IA and Basel II, the three-year Basel II transition period should be put on hold until the regulators determine how to fundamentally revise Basel II.

Attachment:



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President and CEO

June 23, 2006

Honorable Susan Schmidt Bies
Board of Governors of the Federal Reserve System
20th and Constitution Avenue, NW
Washington, DC 20551

Honorable John C. Dugan
Comptroller of the Currency
205 E Street, SW
Washington, DC 20219

Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, Room 6000
Washington, DC 20429

Honorable John M. Reich
Director
Office of Thrift Supervision
1700 G Street, NW, 5th Floor
Washington, DC 20552

Dear Sirs and Madam:

A recent article (attached) raises a very serious concern about the pending interagency guidance on commercial real estate lending. The article treats the proposed thresholds as new buy/sell indicators for investment transactions, regardless of a bank's other business or financial indicators. We are extremely troubled by the application of the proposed guidance in this manner.

The article's author, Richard Suttmeier, president of Global Market Consultants, Ltd. and chief market strategist for Joseph Stevens & Co, applies the proposed concentration thresholds to several banks and recommends adding to or reducing positions in their stock, based only on price targets and on their percentage of CRE loans to capital. The largest banks fare well in this analysis because their huge size means lower ratios of CRE loans to capital. For example, he recommends that investors buy Bank of America stock

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because its ratio is "a mere 29%, below the FDIC 100% threshold" whereas he recommends immediately reducing holdings of the much smaller BB&T Bank because its CRE loans are "way above the FDIC's red line at 197%" for one threshold and "above danger levels at 364%" for the second threshold.

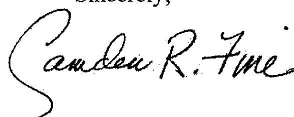
This type of analysis shows that the CRE proposal heavily discriminates against smaller institutions. The proposal will have little effect on the largest banks. In fact, following this analysis, the proposal favors the largest banks, and is a reason to increase holdings in their stock. By contrast, smaller banks and community banks will be negatively affected. This analyst sees the proposed concentration thresholds as absolute cutoff levels, stating that when a bank's commercial development loans exceed 100% of capital, "it's a warning." When CRE loans exceed 300%, "it's a danger sign."

In our April 12, 2006 comment letter, ICBA strongly urged the banking agencies not to go forward with the proposed CRE guidance, and expressed our great concern that the proposal is overly broad, defining concentrations of risk in a manner that cannot assess the true risk in a bank's CRE lending and that disproportionately affects community banks. We reiterate that position.

The proposed thresholds cannot capture true risk because they do not take into account underwriting standards and risk management practices. The thresholds treat all CRE loans as having equal risk. Mr. Suttmeier did not take into account the quality of underwriting standards and risk management practices or risk levels of individual loans when making his "add to holdings" or "reduce holdings" recommendations. Thus, the use of the proposed thresholds does not give a true picture of the risk in a financial institution's portfolio but rather, in this case, misleads the investing public.

The guidance has great potential to precipitate a credit crunch among smaller banks and community banks and severely hamper their ability to provide CRE credit in thousands of cities and towns across America. Again, ICBA urges the banking agencies not to go forward with the guidance as proposed.

Sincerely,



Camden R. Fine
President and CEO

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Active Trader Update

A Landslide Could Bring Down Banks

By Richard Suttmeier
RealMoney.com Contributor
6/14/2006 3:00 PM EDT
URL: http://www.thestreet.com/markets/activetraderupdate/10291754.html

This column was originally published on RealMoney *on June 14 at 1:00 p.m. EDT. It's being republished as a bonus for* TheStreet.com *readers.*

While the massive size and diversification of the biggest U.S. banks have kept their Federal Deposit Insurance Corporation (FDIC) ratios well below red lines indicating overexposure to real estate, the extent of their underwriting in construction lending and multifamily and commercial real estate lending is a matter of concern. If the **Federal Reserve** continues to raise rates, defaults on these types of loans will put a damper on future profits of all the financial institutions participating in what has been a major boom.

The selloff in stocks hasn't affected the finance sector as much as the rest of the market, partially due to the expectation that the Federal Reserve will soon stop raising rates. The finance sector is currently the most overvalued, but by just 3.5%.

It appears that the FOMC is hell-bent to raise the federal funds rate to 5.25% at its next meeting at the end of June. I believe additional rate hikes will increase the probability that defaults on real estate loans will rise.

The top six banks by total assets and Tier 1 capital are **Bank of America** (BAC:NYSE) , **JPMorgan** (JPM:NYSE) , **Citibank** (C:NYSE) , **Wachovia Bank** (WB:NYSE) , **Wells Fargo** (WFC:NYSE) and **Washington Mutual** (WM:NYSE) .

Bank of America has the most exposure to construction loans, followed by Wachovia and Wells Fargo and the smaller banks **SunTrust** (STI:NYSE) and **Branch Banking & Trust** (BBT:NYSE) .

All of the financial institutions in the table below are rated hold by ValuEngine, except for JPMorgan. Only JPMorgan and Wachovia are trading slightly below fair value. The weekly chart profiles are mixed. What's interesting is that BB&T and SunTrust, the stocks that are most exposed to real estate, have positive profiles.

Financial Institutions

	June 13 Price	Rating	(-UV) / OV%	Fair Value	MOM	5-Week MMA	Value Levels	Pivots	Risky Levels
Bank of America	$47.07	HOLD	1.90%	$46.20	DM	$48.50	46.07 A / 44.12 A	48.49 M / 49.59 Q	51.95 S / 54.44 S
BB&T Bank	$42.23	HOLD	6.50%	$39.66	RM	$41.98	40.08 S / 39.85 Q	41.24 M / 41.96 S	52.88 A
Citigroup	$48.21	HOLD	2.80%	$46.89	DM	$49.21	45.44 Q	51.30 M	61.32 A

JP Morgan	$40.53	BUY	-6.80%	$43.49	DM	$43.14	39.85 Q	43.04 M / 43.51 A	49.50 A
SunTrust	$76.39	HOLD	2.80%	$74.31	RM	$76.22	72.83 M / 70.33 Q		87.96 A
Wachovia	$53.04	HOLD	-4.20%	$55.34	DM	$55.19		52.98 Q / 55.89 M	57.84 A
Wells Fargo	$67.07	HOLD	9.00%	$61.56	RM	$67.20	64.30 M / 63.23 S	69.82 A	70.50 S
Washington Mutual	$44.13	HOLD	13.10%	$39.03	RM	$45.15	42.19 M / 41.59 A		47.34 A / 47.67 S

Key: OB, overbought; DM, declining momentum; RM, rising momentum; OS, oversold; M, monthly; Q, quarterly; S, semiannual; A, annual. A value level is a price at which my models project that buyers will emerge; a risky level is a price at which investors are likely to reduce holdings, according to my models. A pivot is a value or risky level that has been breached in its particular time horizon; the stock will likely trade around this pivot.
Source: Global Market Consultants

The FDIC compiles two ratios for financial institutions based on quarterly reporting of their underwriting activities in construction lending and lending for multifamily properties and commercial real estate:

- The CD loans ratio measures construction lending vs. Tier 1 capital. When this ratio exceeds 100%, it's a warning.
- The CRE loans ratio measures the total of construction, multifamily and commercial real estate lending vs. Tier 1 capital. When this ratio exceeds 300%, it's a danger sign.

Bank of America has the largest exposure to construction loans of any financial institution at $20.7 billion, but given its tremendous level of assets, its CD ratio is a mere 29%, below the FDIC 100% threshold. With this balance, investors should add to holdings on weakness to my annual value levels of $46.07 and $44.12 and reduce holdings at my semiannual risky levels of $51.95 and $54.44.

The much smaller BB&T Bank is fifth in the size of its exposure to construction loans at $11 billion, putting its CD ratio way above the FDIC's red line at 197%. Its CRE ratio is also above danger levels at 364%. The stock isn't much below its 52-week high at $43.90. Investors should reduce holdings now, with shares between my monthly and semiannual pivots of $41.24 and $41.96.

Citigroup's exposure to CD loans is only 1% of capital and isn't a major concern for investors. Add to positions on weakness to my quarterly value level of $45.44 and reduce holdings if it rises to my monthly pivot of $51.30.

JPMorgan's exposure to CD loans is only 10% of capital, and it was upgraded to buy Wednesday morning by ValuEngine. With shares trading around my quarterly value level of $39.85, I'd increase my stake now. If it rises to my annual risky level of $49.50, I'd reduce holdings.

SunTrust has the fourth-largest construction-loan portfolio at $12.1 billion, putting its CD ratio at 101%, just over the FDIC guideline. With the stock recently pushing at its 52-week high of $78.33, investors should reduce holdings now, or on a weekly close below the five-week MMA of $76.22.

Wachovia has a manageable CD ratio of 57%. Investors should add to holdings if it falls to my quarterly value level of $52.98 and pare back positions if it rises to my annual risky level of $57.84.

Wells Fargo has a manageable CD ratio of 55%. Investors should add to positions on weakness to my monthly and annual value levels of $64.30 and $63.23 and reduce holdings on strength to my semiannual risky level of $70.50.

Washington Mutual's exposure to CD loans is only 13% of capital. I'd buy more if it drops to my monthly and annual value levels of $42.19 and $41.59 and reduce holdings on strength to my annual and semiannual risky levels of $47.34 and $47.67.

If you have a bank you wish me to profile, send me an email.

P.S. from TheStreet.com Editor-in-Chief, Dave Morrow:
It's always been my opinion that it pays to have more -- not fewer -- expert market views and analyses when you're making investing or trading decisions. That's why I recommend you take advantage of our free trial offer to TheStreet.com's *RealMoney* premium Web site, where you'll get in-depth commentary *and* money-making strategies from over 50 Wall Street pros, including Jim Cramer. Take my advice -- try it now.

Richard Suttmeier is president of Global Market Consultants, Ltd., and chief market strategist for Joseph Stevens & co., a full service brokerage firm located in lower Manhattan. Early in his career, Suttmeier became the first U.S. Treasury Bond Trader at Bache. He later began the government bond division at L. F. Rothschild. Suttmeier went on to form Global Market Consultants as an independent third-party research provider, producing reports covering the technicals of the U.S. capital markets. He also has been U.S. Treasury Strategist for Smith Barney and chief financial strategist for William R. Hough. Suttmeier holds a bachelor's degree from the Georgia Institute of Technology and a master's degree from Polytechnic University.