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Statement

of

John Reich, Director
Office of Thrift Supervision

concerning

Basel Capital and Commercial Real Estate

before the

Subcommittee on Financial Institutions and Consumer Credit
of the
Committee on Financial Services

U.S. House of Representatives

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Office of Thrift Supervision
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1700 G Street N.W.
Washington, D.C. 20552
202-906-6288

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Testimony on Basel Capital and Commercial Real Estate by Office of Thrift Supervision Director John M. Reich before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial Services

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I. Introduction

Good morning, Chairman Bachus, Ranking Member Sanders, and Members of the Subcommittee. Thank you for the opportunity to discuss the views of the Office of Thrift Supervision (OTS) on the recently proposed Basel II capital framework and on the status of pending interagency guidance on commercial real estate (CRE) lending.

Basel II and the CRE lending guidance both raise significant issues affecting U.S. banking organizations. While Basel II primarily applies to the largest internationally active U.S. banks, its implementation affects all U.S. banking organizations. And the proposed CRE lending guidance addresses risk management practices for managing concentration risk exposures, which have risen sharply for certain segments of the industry. Basel II and the CRE guidance are supervisory tools for the federal banking agencies (FBAs), but both also set forth processes designed to enable institutions to protect their capital.

II. Capital

At the core of all effective banking regulation is the concept of bank capital. Capital protects a banking organization from unexpected and unforeseen risks in its business operations and other external risk exposures. Effective capital management requires effective risk management.

The Basel II proposal and the CRE lending guidance are supervisory tools for monitoring and managing risk and institution capital, including potential risks associated with over-leveraging an institution's capital. These FBA initiatives differ, however, in their application. Basel II is a regulatory proposal primarily intended to capture the risks embedded in the largest and most internationally active U.S. banking organizations. By contrast, the CRE lending guidance reminds institutions regarding their risk management practices with respect to concentrations in CRE lending.

III. Basel II

Basel II introduces into the United States a new system to measure capital adequacy and improve risk management at the enterprise-level for our largest banking organizations. While Basel I focused on measuring risk exposure on an asset-by-asset basis, placing assets into simple, broadly defined risk buckets, Basel II requires institutions to maintain and analyze data and assess risk among different loan types. Basel II seeks to promote ongoing improvements in risk assessment capabilities; incorporates advances in risk measurement and management practices; and attempts to assess capital charges more precisely in relation to risk, particularly credit and operational risk. Basel II also envisions that institutions will continue to develop their internal economic capital models to measure their own unique enterprise risk. The international agreement articulating these principles was issued in June 2004.

A. The Basel II NPR

Last week, the Federal Deposit Insurance Corporation's Board of Directors took the final step required for the FBAs to issue a notice of proposed rulemaking (NPR) on the Basel II "Advanced internal ratings based" – or "models based" – approach. As part of the NPR, the FBAs are inviting comment on the merits of the Basel II Standardized – or "non-models based" – approach.

There are several issues raised by the NPR for which public comments are important to assist the FBAs in navigating the best course for this rulemaking. The most important issue is whether the NPR achieves its primary objective of capturing the risks embedded in the largest and most internationally active depository institutions, and whether this is accomplished in a clear and transparent manner. It is my hope that the NPR provides sufficient and useful information regarding the application of Basel II in the United States to stimulate comment on the various strengths and weaknesses of the Basel II approach. And I am particularly hopeful that we succeeded in addressing the concerns and issues raised by the results of the QIS-4 data collection conducted by the FBAs last year.

While OTS supports Basel II, we do so with the understanding that full U.S. implementation will occur only when the FBAs are confident that these changes will strengthen our banking system. The FBAs already revised the proposed timeframes for U.S. implementation of Basel II by delaying the start to 2008 and extending the phase-in period by one year. We also included the following safeguards in the NPR:

- There will be a parallel run of the Basel II framework starting in 2008. Institutions will be able to participate in the parallel run only if they can demonstrate to their primary federal regulator that they have accurate and reliable systems in place for enterprise-wide risk management.
- There will be a minimum three-year transition period during which the FBAs will apply graduated limits on the amount by which each institution's risk-based capital can decline under Basel II.[1] For each year, an institution's primary federal regulator will assess an institution's readiness to operate under the graduated limits, as well as on the termination of the floors for the institution after 2011.
- Based on information received throughout the implementation process, the FBAs will continually evaluate the effectiveness of the Basel II-based capital rules. Pursuant to this,

1. The phase-in schedule provides that, in the first year (2009), an institution's capital reduction is subject to a floor of 95 percent of the level calculated for risk-weighted assets under Basel I. Reductions in risk-weighted assets would be limited to a 90 percent floor in the second year of implementation (2010), and an 85 percent floor in the third year (2011). Supervisory approval is required in each successive year to go to the next floor. During implementation, an institution's primary federal regulator will closely monitor its systems for gathering and maintaining data, calculating the Basel II capital requirement, and ensuring the overall integrity, and safety and soundness, of the application of the Basel II framework.

the FBAs anticipate the possibility of further revisions to the Basel II rules prior to the termination of the floors (see footnote 1).

- Existing Prompt Corrective Action (PCA) and leverage capital ratio requirements will remain in effect as underpinnings of U.S. capital requirements.
- If aggregate industry capital falls by more than 10 percent, the FBAs may elect to recalibrate the framework.

The FBAs are currently working toward issuance of a final Basel II rule in mid-2007. This timetable is necessary for U.S. institutions to have sufficient lead-time to prepare for a 2008 parallel run. However, with a comment period extending into January 2007, even that delayed target date may be ambitious. Further rulemakings may also be necessary to refine the Basel II framework for use in the U.S. pending the outcome of the parallel run and subsequent implementation stages.[2]

As we develop a more sophisticated risk-based capital framework, it is important that we also consider the Standardized approach – the less complex alternative to the Basel II models-based approach. The Basel II NPR solicits comment on this alternative. I believe it is important for the FBAs to consider whether the Standardized approach could achieve many of the same goals as the models-based approach at a lower cost and with greater clarity and transparency.

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2. It is also important to note that OTS, like the OCC, is subject to Executive Order 12866, which requires executive agencies to determine whether a proposed rule is a "significant regulatory action." OTS has determined that the Basel II NPR will be a significant regulatory action based on the potential effects of the rule. Thus, OTS is required to prepare a regulatory impact analysis of the NPR, including an analysis of the need for regulatory action, the costs and benefits of the NPR and alternative approaches, and the potential impact on competition among financial services providers. Pursuant to the Executive Order, the NPR and accompanying regulatory impact analysis will be submitted to the Office of Management and Budget for review prior to publication of the NPR.

B. Basel II and Modernization of the Basel I Capital Standards – the Basel IA Proposal

Last year, the FBAs issued an Advance Notice of Proposed Rulemaking (ANPR) soliciting comment on modernizing the existing Basel I rules, referred to as Basel IA. OTS was an early advocate of revising and modernizing Basel I. We strongly support amending the existing Basel I standards simultaneously, or in close proximity to Basel II. Modifying the existing rules with more accurate risk-weights allocated to a wider range of asset buckets will improve the risk sensitivity of the current capital framework without unduly burdening affected institutions.[3] Applying commonly used risk criteria for identifying different levels of risk will further enhance our capital rules.

In considering revisions to our current capital rules, the following principles guided the FBAs:

- Promoting safe and sound banking practices and maintaining a prudent level of regulatory capital;
- Maintaining a healthy balance between risk sensitivity and operational feasibility;
- Avoiding undue regulatory burden; and
- Mitigating material distortions in the amount of regulatory risk-based capital requirements for large and small institutions.

Basel IA is intended to increase risk sensitivity and minimize potential competitive inequities from Basel II; however, many highly capitalized banking organizations have indicated they prefer to continue operating under their current Basel I framework. I am particularly dedicated to the proposition that we should not burden these institutions and I support this flexibility, consistent with the need to balance safety and soundness with regulatory burden concerns.

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3. Current categories are 0, 20, 50, 100 and 200 percent, and possible new and additional categories for consideration are 10, 35, 75, 150 and 350 percent.

C. Public Policy Concerns with Basel II and the Basel IA Proposal

Longstanding capital adequacy standards combined with a well-established and highly effective supervisory structure have delivered a U.S. banking system that is healthy and robust. As we move forward to modernize our capital rules, it is important that we do not harm or unduly burden our banking system.

Implementing more risk-sensitive capital requirements without undue burden is as important for small community banking organizations as it is for large internationally active institutions. Achieving greater risk sensitivity for one part of the banking system and not the whole will inevitably create competitive distortions. While global capital standards are important, we must avoid potential negative effects on U.S.-based institutions not operating internationally.

A final issue that has generated significant discussion is the continued application under Basel II of PCA, including a leverage ratio. PCA provides a graduated capital structure for identifying categories of capital adequacy based on both leverage ratio and risk-based capital. Along with other prudential safeguards, leverage is an important capital buffer. OTS remains committed to maintaining an appropriate leverage ratio.

IV. Commercial Real Estate Lending Guidance

On January 10, 2006, the FBAs published for public comment draft guidance on sound risk management practices for concentrations in commercial real estate (CRE) lending. The proposed guidance was issued in response to the rapid growth in CRE concentration levels at insured institutions with assets between $100 million and $10 billion. While there has been moderate growth in CRE lending by the smallest and largest depository institutions, annual growth in CRE lending by small-to-midsized community banks and small-to-midsized regional banks has risen dramatically since 1998.[4]

The proposed CRE guidance reminds institutions that credit concentrations can pose substantial risks and that these risks should be assessed and appropriately addressed. Risk management practices should be commensurate with the level of concentration risk present at an institution.

The draft guidance drew numerous comments, including concerns with the potential impact on community lending. It is important to note that the proposed guidance is not intended to diminish the vital role of community banking in providing credit for business and real estate development. Rather, it is intended to preserve the health and continued profitability of the institutions that serve these community lending needs.

Other comments on the guidance were that it will impose additional burdens on depository institutions and that thresholds set forth in the guidance will be viewed as hard limits by examiners and the industry. As a former community banker, I am keenly sensitive to both of these issues. Again, my expectation is that the guidance should be viewed only as a reference by the industry and our examiners. In fact, the proposed guidance is not proscriptive and does not impose any limits on the amount of CRE lending that an institution may conduct. It merely seeks to ensure that institutions maintain sound underwriting and risk management and review practices to monitor their CRE credit exposures.

Industry comments also noted that various CRE loans have vastly different loan characteristics and should not be viewed as a single risk category. I believe that this is a valid point. It has been OTS's experience that certain assets, such as multi-family housing, even in larger amounts, generally do <u>not</u> pose inordinate credit risk. By contrast, other assets, even in

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4. Since 1998, institutions with total assets of $100 million to $1 billion have increased their percentage of total CRE loans to total risk-based capital by more than 15 percent annually, from 175 percent in 1998 to approximately 310 percent in the first quarter of 2006. Similarly, institutions with assets of between $1 billion to $10 billion have increased their percentage of CRE lending from 135 percent in 1998 to almost 290 percent in the first quarter of 2006, representing an annual increase approaching 20 percent.

small amounts, can pose a credit risk; thus we have concerns about the insertion of triggers in the guidance which may be perceived as caps, and the resulting impact of such guidance on lending nationwide. As set forth in the CRE guidance, we do expect institutions to assess their exposure to concentration risks based on their own portfolio experience, and to take appropriate actions to manage these risks.

Additional industry comments noted that most institutions are well capitalized and capital requirements should be addressed on a case-by-case basis; expressed concern regarding the potential for inconsistent implementation of the guidance; and stated the view that the FBAs already have the regulatory tools necessary to address problems and require additional capital when appropriate at individual institutions.

In light of the comments we received, the CRE guidance is in the process of being redrafted by the FBAs. It is my expectation that we will modify the guidance to address the comments, to clarify the underlying theme of FBA risk management expectations for the industry, and to make sure the guidance conveys this intent more clearly.

V. Conclusion

OTS supports the goals and objectives of Basel II, and we are committed to implementing a more risk-sensitive capital framework for all our regulated institutions. We look forward to continuing the dialogue with the industry, Congress and our fellow regulators regarding Basel II and the parallel implementation of a Basel IA rulemaking. The NPR seeks comment on the Standardized non-models based capital approach as well as the Advanced models-based approach. We will continue to work with the Subcommittee and the other FBAs throughout the Basel process. We encourage all interested parties to comment and participate fully in the development of the important policy objectives of Basel II and IA.