STATEMENT OF

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on

INTERAGENCY PROPOSALS REGARDING THE BASEL CAPITAL ACCORD AND COMMERCIAL REAL ESTATE LENDING CONCENTRATIONS

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Chairman Bachus, Representative Sanders and members of the Subcommittee, I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) concerning the Basel II international capital accord and the federal banking and thrift agencies' recent draft guidance on commercial real estate lending.

Basel II and the commercial real estate guidance share one important feature: a focus on the importance of risk management. A sound internal framework and system of controls for managing risk are critical to the soundness of any bank, large or small. For the largest and most systemically important banks, supervisors expect the highest quality of risk management consistent with their size and complexity.

<u>The Importance of Capital</u>

The U.S. banking system is a network of institutions that are highly leveraged and whose financial health bears directly on the health of our broader economy. Significant problems or a lack of financial flexibility at many small banks, or at one or more large systemically important banks, can have contagion effects that impose significant costs on the deposit insurance funds and the overall economy. The special role of banks in our economy creates a federal interest in their sound operation and the adequacy of their capital.

Economic theory describes an important rationale for bank capital regulation. The theory asserts that banks may tend to hold less capital than is optimal for prudential purposes. When calculating economic capital needs, banks do not consider the substantial costs that their potential failure would impose on other parts of the economy. In addition, a bank's depositors and creditors benefit from explicit and perceived safety-net protections. This benefit lowers the premium banks must pay for deposits and other forms of debt. The result is a greater proportion of debt and a lower proportion of capital in banks' overall funding mix than would exist in the absence of federal safety net support.

In the United States, we have a dual system of bank capital regulation. Banks' Tier 1 capital, the high-quality capital that is most critical in absorbing losses, is required to exceed defined percentages of balance sheet assets. This leverage ratio requirement provides a baseline of capital for safety-and-soundness purposes. However, the leverage ratio does not address all risks. For example, it does not address the risks of off-balance sheet positions. Risk-based capital requirements provide a second measurement of capital to capture risks that are not addressed by the leverage ratio.

The purpose of the Basel II process is to improve the current risk-based capital requirements. In designing and implementing these improvements, it is important to recognize both the inherent limitations on the ability to precisely measure bank risk, and the fundamental fact that supervisors' and banks' objectives in the capital regulation process are not always the same. Thus, the more reliance the risk-based capital regulation places on banks' internal risk estimates, the more important is the hard-and-fast capital baseline provided by the leverage ratio. As discussed later in this testimony, the critical importance of the leverage ratio in the context of the Advanced Approaches of Basel II is an issue that is worthy of discussion in the international arena, as well.

Basel II

As you know, Basel II is an international effort by financial institution supervisors with the laudable goal of creating standards for capital requirements that are more risk-sensitive and promote a disciplined approach to risk management at this country's largest banks. Basel II also is intended to address concerns that the regulatory arbitrage opportunities available under Basel I threaten the adequacy of the regulatory capital buffer needed to ensure financial system stability. U.S. bank regulators also are developing a more risk sensitive capital framework known as Basel IA for non-Basel II banks.

Basel II includes several options for banks to calculate their risk-based capital requirements. Basel II's Advanced Approaches allow banks to determine their risk-based capital requirements by using their own estimates of key risk parameters as inputs to formulas developed by the Basel Committee. The Advanced Approaches also contain an operational risk capital requirement that is based on each bank's own estimates and models of its potential operational losses. The key risk parameters used to determine capital requirements for credit risk and operational risk in the Advanced Approaches are subject to supervisory review. The principal issues with respect to the Advanced Approaches revolve around how banks will set their risk inputs and the formulas that translate these inputs into capital requirements. The Advanced Approaches to Basel II include significant expectations for banks to have high quality risk management systems and have stimulated banks' efforts in this area.

Basel II also provides for a Standardized Approach to calculate risk-based capital requirements. The Standardized Approach includes a greater array of risk weights than the current rules, an expanded set of options for recognizing the benefits of collateral and other credit risk mitigants, and new options for computing exposures to derivatives. In addition, the Standardized Approach includes new capital requirements for certain exposures not captured by the current rules, such as short-term loan commitments and the potential for early amortization of revolving credit securitizations. The Standardized Approach also includes a capital charge for operational risk.

The FDIC Board of Directors voted to publish the Basel II Notice of Proposed Rulemaking (NPR) for public comment on September 5, 2006. As the U.S. banking and thrift agencies proceed with the deliberative process for implementing Basel II, it is important that the new capital framework does not produce unintended consequences, such as significant reductions in overall capital levels or the creation of substantial new competitive inequities between certain categories of insured depository institutions. In this regard, there clearly remain several outstanding issues with the proposed rule.

The first of these issues is the impact of the new framework on minimum capital requirements. One of the important premises on the part of financial supervisors for moving forward with Basel II was an expectation that it would not cause a substantial reduction in minimum capital requirements. The agencies concluded, however, that without additional safeguards, implementing the Advanced Approach formulas could produce unacceptably large reductions in risk-based capital requirements.

For example, half of the banks surveyed in the recent U.S. Quantitative Impact Study (QIS-4) reported that the Basel II formulas would reduce their minimum Tier 1 capital requirements by more than 31 percent, with a dollar weighted average reduction of 22 percent. Almost all of the banks participating in the QIS-4 reported Tier 1 capital requirements that, if implemented, would not be permissible under the current U.S. leverage ratio requirements.

The large reductions in capital requirements reported in the QIS-4 probably do not reflect the full impact of the Basel II proposals. Among other things, the QIS-4 results do not incorporate the effect of important changes in the Basel II methodology for computing exposures to derivatives and other counterparty credit risks. These new methodologies will likely reduce capital requirements for these exposures in a way that was not reflected in the QIS-4. On the other hand, the QIS-4 does not reflect the impact of the 1.06 conversion factor produced by the so-called “Madrid” compromise that would partially offset the reduction in capital requirements that would otherwise be expected under the Advanced Approaches.

Another issue of concern is a lack of an objective process within the Advanced Approaches for producing similar capital requirements for similar risks. The QIS-4 showed that similar risks received very different capital requirements across the participating banks. The framework allows banks substantial flexibility in how they develop risk inputs. It remains unclear how to reconcile the twin goals of individual bank flexibility within the Advanced Approaches and regulatory consistency across banks.

These basic concerns about substantial reductions in capital requirements and lack of consistency under the Advanced Approaches create an additional concern about unintended competitive effects. Implementing the formulas in the Basel II Advanced Approaches without additional limitations could create a substantial difference in risk-based capital requirements between large and small banks. With the exception of credit card lending, banks using the Advanced Approaches likely will have substantially lower risk-based capital requirements than other banks, even with the changes to the general capital rules for other domestic banks under consideration as part of the Basel IA rulemaking (discussed in more detail later in the testimony). Given the wide variation in capital requirements for the same risks that are possible in the Advanced Approaches, unintended competitive effects also may develop among banks using the Advanced Approaches whose internal methodologies reflect differing degrees of conservatism.

Concerns with the Advanced Approaches, with respect to undue reductions in capital requirements and inconsistent requirements, are not unique to the FDIC. All U.S. bank and thrift supervisors viewed the QIS-4 results as unacceptable and agreed to include substantial safeguards within the Basel II NPR to address those concerns. These include: the retention of the leverage ratio; an additional transition year; a more conservative set of transitional capital floors during those transition years that would apply at the individual bank level; and an aggregate 10 percent downward limit on reductions in risk-based capital requirements that would trigger regulatory changes if exceeded.

The next step in the process will be a public comment period following the publication in the *Federal Register* of the Basel II NPR, along with an NPR on changes to the market risk regulations (Market Risk NPR). In addition, the agencies will publish two notices in the *Federal Register* that will propose certain sets of regulatory reporting templates (referred to as reporting requirements in the NPRs) that insured depository institutions and holding companies will use to report key aspects of their capital calculations under the Basel II and Market Risk NPRs, respectively, on a quarterly basis. The Market Risk NPR will propose to update the agencies' market risk regulations to address strategies banks employ to use their trading books to lower capital requirements in ways that were not originally intended. The regulatory reporting templates will provide for public disclosure of the basic elements of each bank's risk-based capital calculation. A more extensive set of confidential supervisory reports will be shared among the regulators and used for benchmarking, trend analysis and quality assurance purposes. The data also will be used to evaluate the quantitative impact of these rules and their competitive implications on an industry-wide and institution specific basis, and to supplement the on-site examination process. The industry and the public are being asked to provide substantial comment on all aspects of these proposals.

As the members of this Committee are aware, the federal agencies have received a number of letters in recent months requesting that U.S. core banks (large and internationally active institutions that are required to implement the Advanced Approaches of Basel II) and other banks be given the option of using the Standardized Approach to capital regulation that is part of the international Basel II Accord (Standardized Approach).

The letters question whether any bank should be required by regulation to adopt the Advanced Approaches of Basel II and whether an alternative framework should be available in the U.S. Of the Basel Committee countries, the U.S. is the only country proposing regulatory requirements that would make the Advanced Approaches mandatory for certain banks. Supervisors in some Basel Committee countries have informally made clear their expectations for their largest banks to use the Advanced Approaches. Supervisors in other Basel Committee countries have indicated they have no such expectation and that the choice among the capital frameworks offered in the Basel II Accord is entirely the decision of the banks.

If the Advanced Approaches are not mandatory, an important question is what capital rules will be used in their place? Current risk-based capital rules supplemented by elements of the more risk-sensitive capital framework being developed for non-core domestic banks contain some of the elements of the Standardized Approach with a few important differences. For example, there are specific differences in risk weights between the Basel Standardized Approach and Basel IA. In addition, Basel IA does not include an operational risk capital charge. Finally, the Standardized Approach allows qualifying banks to use some of the same new methodologies for computing capital requirements for derivatives and other counterparty credit risks that are available to banks using the Advanced Approaches.

One argument in favor of allowing core banks to use some version of the Standardized Approach instead of the Advanced Approaches is that such an approach would be a simpler and less costly way to improve the risk sensitivity of existing capital regulations. Also, the Standardized Approach does not pose the same potential for a large reduction in capital requirements and consequently would not pose the same potential for significant competitive inequities. On the other hand, some argue that excusing core banks from the requirement to adopt the Advanced Approaches would have a deleterious effect on the evolution of the core banks' risk management practices over the long term.

In short, a fundamental issue is whether the core banks should be permitted alternative approaches provided by the Basel II Accord. The Basel II NPR seeks comment on this important question and public input will be valuable in evaluating this issue.

The federal banking agencies also will issue the Basel IA NPR in the relatively near term covering changes in the capital regulations for non-core domestic banks. Basel IA is expected to be a more risk-sensitive capital framework than the current capital rules and may appeal to some community banks. However, many, if not most, community banks are content to operate under the current risk-based requirements and do not wish to be subject to Basel IA. This is another area where public and industry comment will be valuable. The Basel IA NPR also will solicit comment on whether these rules should be available to all U.S. banks, and whether additional elements of the Basel II Standardized Approach should be incorporated into the U.S. rules for Basel IA.

Over the long term, there may be a need to think creatively about other ways to move forward. Most of the prescriptive elements of the Advanced Approaches can be attributed to the regulators' realization that, without clear standards, the Advanced Approaches could have problematic safety-and-soundness implications. Banks, on the other hand, chafe at the prescriptive elements and want to be able to use their internal models to set regulatory capital.

As capital requirements continue to evolve, it is critical to preserve the strengths that exist today. As mentioned earlier in my testimony, the U.S. has a dual framework of capital regulation: a leverage ratio, which is a simple ratio of capital to balance sheet assets, and the more complex risk-based requirements. The risk-based and leverage components of capital regulation work well together. The leverage requirement provides a baseline level of capital to protect the safety net, while the risk-based requirement can capture additional risks that are not covered by the leverage framework.

The Basel Committee acknowledged that other measures of capital adequacy might be appropriate, stating in the New Accord "that national authorities may use a supplementary capital measure as a way to address, for example, the potential uncertainties in the accuracy of the measure of risk exposure inherent in any capital rule or to constrain the extent to which an organization can fund itself with debt."

I believe that further consideration of other measures of capital adequacy, such as the leverage ratio, should be initiated by the Basel Committee, which would provide a broader perspective on this important issue. The establishment of an international leverage ratio would go far in strengthening the soundness and stability of the international banking system. Such an agreement also would help to ensure that differences in capital requirements do not lead to competitive inequality among internationally active banks. These are fundamental objectives of the Basel Committee's work in revising the 1988 Basel Accord.

In addition to maintaining a simple baseline measure of solvency, the leverage ratio provides U.S. supervisors with a great deal of comfort that banks will maintain a stable base of capital in good times and in bad times. The U.S. banking system will not be subject to the same degree of volatility in capital requirements that other countries will likely experience once they adopt the Advanced Approaches.

Another favorable aspect of a simple capital-to-assets measure is that it limits balance sheet growth to manageable levels and serves as a powerful check against excessive leverage, which has been a longstanding concern of supervisors across the world. A more highly capitalized banking system provides investors with greater comfort and provides banks with greater access to the capital markets for liquidity and funding. The U.S. banking system has flourished under this dual capital framework as banks continue to generate record profits and provide investors with healthy returns on equity.

A recent paper written by economists at the Swiss National Bank (although not necessarily representing the position of the central bank) hits squarely upon issues that confront the international supervisory community in the move toward approaches based on models for determining capital adequacy. In that paper, the authors advance the view that ". . . it is essential that optimal risk-sensitive capital requirements be complemented by a capital floor that does not depend on the riskiness of banks' activities. By setting a floor to banks' absolute (unweighted) capital ratio, a limit can be set to the consequences arising out of the shortcomings of a risk-weighted capital requirement scheme."[1]

The paper even took issue with one of the often mentioned shortcomings of the leverage ratio—that its crude approach to measuring capital adequacy invites regulatory arbitrage. In their paper, the authors note that "the incentive to take advantage of regulatory arbitrage opportunities and to incur excessive risks will be strongest at low

[1] Robert Bichsel and Jurg Blum, "Capital regulation of banks: Where do we stand and where are we going?" *Swiss National Bank Quarterly Bulletin* (April 2005).

levels of capital." The paper also notes that, "the consequences of underestimating the riskiness of banks are particularly damaging when the capital base is low." This is a sobering message, and one that I believe is deserving of further discussion among international banking supervisors as we continue to grapple with the issues associated with adopting models-based capital regulations.

<u>Interagency Guidance on Concentrations in Commercial Real Estate Lending</u>

In addition to a new international capital framework, federal regulators also are monitoring traditional risk issues, such as concentrations in commercial real estate lending. Commercial real estate lending at community banks has grown substantially in recent years. At the end of March 2006, commercial real estate loans accounted for more than 42 percent of all loans at institutions with less than $1 billion in assets. Six years ago, these loans represented less than 28 percent of all loans at these institutions. Real estate construction and development continued to lead commercial real estate loan growth, growing by $34.5 billion (7.7 percent) in the first quarter, and the volume has grown by 35 percent over the previous twelve months.

Commercial real estate markets also experienced strong growth in the early and mid 1980s, but declined significantly in the late 1980s and early 1990s. At that time, banks with significant concentrations of commercial real estate loans suffered large losses during the decline, and some failed. The FDIC is careful not to draw too many parallels between today's commercial real estate market and that of the 1980s. Many external factors contributed to the boom and bust in the 1980s. Tax law changes, deregulation of thrift institutions that were inexperienced in commercial real estate lending and unregulated appraisers all contributed to the volatility. In addition, many of the commercial real estate loans that banks made in the 1980s funded speculative office building construction. The FDIC's on-site supervisory experience indicates that many of the banking industry's current commercial real estate loans have funded pre-sold housing development. Finally, although evidence suggests some recent slippage, underwriting in the industry is generally more stringent today than in the 1980s.

Commercial real estate remains a cyclical business. However, the risk management of commercial real estate lending has changed with developments in risk-based capital, real estate lending standards that include limits on high loan-to-value loans, appraisal requirements, an active secondary market for commercial real estate loans and improved information availability on local supply and demand. An institution's compliance with these real estate-related regulations and standards is assessed at every examination, as is loan quality and any lending concentration. The FDIC also conducts ongoing analysis of commercial real estate markets. While the rapid price appreciation seen in recent years in several locations is certainly not sustainable over the long-term, we do not anticipate a wide-spread decline in prices. Overall, market fundamentals are generally sound and FDIC economists do not foresee a crisis on the horizon.

Today, almost one-third of institutions report commercial real estate loans[2] in excess of 300 percent of capital—significantly more than the peak of the 1980s. Concentrations add a dimension of risk that needs to be appropriately identified and managed, and some examinations have revealed that portfolio management practices may not have kept pace with growth in banks' commercial real estate portfolios. Therefore, on January 13, 2006, the bank and thrift regulators jointly issued for comment proposed guidance entitled, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices."

Summary of the Proposed Interagency Guidance

The proposed guidance was intended to increase awareness of commercial real estate exposures at insured institutions, reinforce existing regulations and guidelines for real estate lending, and remind institutions that strong risk management practices and appropriate levels of capital are necessary to mitigate the potential risks of concentrations. The proposed guidance was built around four principles: (1) if an insured institution has construction and development loans in excess of 100 percent of capital or total commercial real estate loans in excess of 300 percent of capital, the institution should have heightened risk management practices; (2) senior management should be active in the oversight of the institution's commercial real estate lending strategy and should establish policies and processes that identify, measure, monitor, and control concentration risks; (3) management should monitor commercial real estate markets and

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[2] This calculation includes loans secured by owner-occupied properties which are excluded from the definition in the proposed guidance. Call and Thrift Financial Reports are being expanded to capture these data.

consider its potential impact on the institution's loan portfolio; and (4) higher levels of capital and reserves may be necessary to mitigate high levels of risk.

Industry Reaction to Proposed Guidance

The FDIC received over 1,000 comment letters from bankers, trade organizations, holding companies, state regulators, and others on the proposed guidance. Commenters interpreted the proposed guidance as new regulatory requirements for banks involved in commercial real estate lending—a staple of many banks' operations. The comments centered around four concerns: (1) the definition of commercial real estate was overly broad and covered too many property types that had different risk characteristics; (2) the 100 percent and 300 percent thresholds would become new regulatory limits; (3) the recommended risk management practices were overly burdensome; and (4) the guidance promulgated new capital requirements without specific details. While the overwhelming sentiment was negative, the comments provided valuable information that will result in much improved and useful guidance for the industry.

Current Status of Interagency Guidance

Banking institutions play a vital role in providing credit for business and real estate development, and the intent of the guidance is not to discourage institutions from originating commercial real estate loans. Conversely, the proposed guidance reminds institutions that there are substantial risks posed by a credit concentration and outlines the agencies' recommended best practices for recognizing and addressing those risks.

The FDIC and the other banking agencies seriously considered commenters' views on the proposed guidance. The agencies agree with the need to emphasize that the stated thresholds are not limits, recognize that commercial real estate categories may have different risk characteristics, and stress that risk management practices should be commensurate with the complexity of the institution and its activities. It is important to note that the proposed guidance does not suggest changes to the risk weights that are applied to commercial real estate for risk-based capital purposes and the appropriateness of an institution's capital level will continue to be analyzed in light of its specific risk profile. With the above changes and clarification from the draft proposal, the final guidance should be a useful tool for banks that emphasizes fundamentally sound credit principles and industry best practices.

Conclusion

This concludes my statement. The FDIC appreciates the opportunity to testify regarding Basel II and the commercial real estate guidance. These aspects of risk management are of fundamental importance to financial institutions. I look forward to any comments provided by the Committee and will be happy to answer any questions.