

TESTIMONY OF

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On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

REGULATORY PROPOSALS ON BASEL CAPITAL AND COMMERCIAL REAL ESTATE

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Good morning, Chairman Bachus, Ranking Member Sanders, and distinguished members of the Subcommittee. My name is Steven L. Antonakes, and I serve as the Commissioner of Banks for the Commonwealth of Massachusetts. I am pleased to testify today on behalf of the Conference of State Bank Supervisors (CSBS). Thank you for inviting CSBS to discuss the Basel II Notice of Proposed Rulemaking (NPR) and proposed commercial real estate (CRE) lending guidance.

CSBS is the professional association of state officials responsible for chartering, supervising, and regulating the nation's 6,230 state-chartered commercial and savings banks, and 400 state-licensed foreign banking offices nationwide. For more than a century, CSBS has given state bank supervisors a national forum to coordinate, communicate, advocate and educate on behalf of state bank regulation. What sets the U.S. financial system apart from the rest of the industrialized world is a broad-based and diverse banking industry marked by charter choice. Choice enables economic opportunity as well as a healthy dynamic tension among regulators, resulting in a wider range of products and services for businesses and consumers, along with lower regulatory costs and more effective, more responsive supervision. I am pleased to be here today with my fellow banking regulators to discuss two such timely and important issues that will affect the American banking system.

The Basel II NPR and the proposed CRE guidance are of great interest to CSBS because of their potential effect upon the banking system. Currently, ten states, including my home state of Massachusetts, charter banks that are potential core Basel II banks or are likely to opt-in to the Basel II framework. These ten states will be directly impacted by the implementation of Basel II. All regulators must be cognizant that these proposals could

alter the competitive landscape and lead to the shifting of risk among business lines within the system.

Most important, however, CSBS is concerned about the overall capital level in the system. My fellow state supervisors and I have traditionally been conservative with regards to capital requirements because of the pivotal role capital plays in ensuring safety and soundness and in stimulating economic growth. Sufficient capital levels are a prerequisite in maintaining the safety and soundness of an institution. As you know, capital provides a cushion, or safety net, for an institution in the event of an economic downturn. Overall, the U.S. economy has been strong and performing well for over a decade now. And while we are currently enjoying a record-breaking period without a bank failure, the last one occurring in June 2004, it is unlikely that this trend will continue uninterrupted forever.

Obviously, the failure of an internationally active or nationwide bank would shake the system and have severe ramifications. Conversely, the failure of a small bank or a community bank would have little effect on the banking system as a whole. But the role that a small bank plays in a local economy cannot be overestimated. I am sure each of you is well aware of the benefits that are added to your districts by healthy, well-capitalized banks of all sizes. As a state supervisor, I am very concerned with the disruption that would be caused by a small bank failure in the communities I have sworn to serve. It is in all of our best interests as bank regulators and legislators to ensure that banks, large and small, remain competitive, manage their risks, and maintain adequate levels of capital. If one or both of these proposals is implemented, the competition and risk within the banking system in the United States will be altered. It is our responsibility to ensure that changes in

capital requirements are prudent, do not negatively alter the competitive landscape, and the transition is carefully managed.

With regards to the Basel II NPR, CSBS is fully supportive of the effort to provide enhanced risk sensitivity to capital regulation. CSBS supports improving risk management, while maintaining the level of aggregate risk-based capital in the system. In our opinion, this is a wise course of action to pursue to ensure the continued safety and soundness of our financial system.

Recently, CSBS requested that the federal agencies seek public comment on offering the Standardized Approach in the United States. While we do not necessarily endorse the adoption of the Standardized Approach, the issue should be open for public debate and may be a solution to the competitive concerns of the Advanced Approach of Basel II. The agencies have included such a question in the NPR, and we commend them for doing so.

CSBS is also pleased with the inclusion of several safeguards that have been incorporated into the Basel II NPR. Primarily, the maintenance of the current leverage ratio is crucial in preserving safety and soundness in the system. My fellow state supervisors and I believe strongly that the preservation of the leverage ratio is an absolutely necessary component of the Basel II framework. As the NPR itself states, “the leverage ratio is a straightforward and tangible measure of solvency and serves as a needed complement to the risk-sensitive Basel II framework based on internal bank inputs.”

A second useful safeguard is the trigger of regulatory changes if there is a material reduction in minimum regulatory capital. If a 10 percent or greater drop in aggregate capital occurs among the group of institutions that adopt the Basel II framework,

regulatory changes will be required of the supervisory risk functions of the framework. CSBS is wary of any proposal that could possibly lower the overall level of capital in the banking system, so we are pleased with the inclusion of this safeguard.

And finally, the proposed transition period is a wise approach to ensure that institutions are fully prepared for the implementation of the Basel II framework. The required one-year parallel run and the three-year implementation period will make certain that institutions are able to adopt the advanced Basel II approach while maintaining adequate capital to ensure safety and soundness. This transition will also give us the opportunity to evaluate the competitive implications and relative strength of the system.

While CSBS is satisfied with the incorporation of the above safeguards in the Basel II NPR, we do have additional concerns that need to be addressed. The state supervisors oversee and regulate the vast majority of financial institutions in this nation. Despite our status as the primary supervisor for most institutions, we have not been included in the drafting process of the Basel II NPR, or the Basel 1A NPR. We believe it would be appropriate for state regulators, through CSBS, to have a seat at the table along with our fellow regulators when rules that affect our institutions to such a great degree are being considered. CSBS should, at the very least, have access to draft proposals well in advance of the traditional public comment period.

Additionally, the Basel II NPR currently does not provide a defined role for the states during the qualification process. The NPR repeatedly refers to an institution's "primary federal supervisor" as being responsible for qualification and transition to the Basel II framework. As I stated above, there are ten states, including Massachusetts, that charter potential Basel II banks. For these state-chartered, Basel II eligible banks, the state

is their primary regulator. As the primary regulator for all banks chartered by the Commonwealth of Massachusetts, the Massachusetts Division of Banks must have a part to play in the qualification process. The states must have a role in the implementation of the Basel II framework, but the federal agencies fail to address this issue in the Basel II NPR.

Once Basel II is adopted and implemented, the states will be responsible for ensuring that our affected institutions are Basel II compliant. In order to do so, we must be able to compare the data of our Basel II institutions against data of other Basel II institutions. Therefore, the state supervisors must have access to confidential data for all Basel II banks after implementation. Information sharing with the federal agencies is a necessary tool for states to properly supervise and regulate state-chartered institutions.

Despite the fact that state-chartered institutions will be directly impacted by the changes to the capital rules, there is the view from some of the agencies that since these rules are federal regulations, there is no part for the states to play in their development or implementation. We believe the exclusion of state regulators from this process is fundamentally wrong. As the members of the subcommittee are well aware, the United States operates under a dual-banking system. The states should be authorized, as the chartering agent for the majority of U.S. banks, to have a role in the development and implementation of rules which directly impact state-chartered banks. We are hopeful that Congress will pass the Regulatory Relief bill, giving state regulators a vote on the Federal Financial Institutions Examination Council (FFIEC) as included in the Senate version of the bill. If passed, the bill will provide a vehicle to address these concerns.

In reference to the proposed CRE guidance, we applaud the federal regulators focus on rising concentration and share many of the concerns that motivated the guidance. However, we fear the guidance will effectively become regulation that will pose unequal and unnecessary burden on community banks. Supervisory tools are already available and actively used by regulators to effectively deal with unsafe practices and unsound concentrations in CRE lending.

It is valuable to look ahead and try to identify areas that may be problematic in the future. CRE lending, however, is a market that is being managed successfully. The states scrutinize their chartered institutions to verify that risk mitigation measures are being properly applied. Field examinations have illustrated that CRE risk is being successfully identified and managed. For example, some of my fellow state regulators have participated with federal regulators on joint examinations at institutions with high CRE concentrations. In virtually all cases, either risk management practices were deemed sufficient or corrective action was implemented in a timely manner.

As regulators, we must not be overly or broadly prescriptive in how risk is managed. The requirements of the proposed guidance would place additional burden on all institutions, but would place particular regulatory burden on community banks. The proposal would entail significant costs and would be of little value to community banks. Advanced and sophisticated risk mitigation measures in place at a large institution are not necessarily compatible or practical if utilized by a small institution. The CRE market is one market where banks of various sizes are still competitive. Large institutions have very complex, diverse portfolios, allowing them to mitigate risk by doing business in other markets. Community banks are not always allowed this opportunity. The guidance fails to

recognize perhaps the greatest risk mitigation tool available to community banks—the proximity of the lender to the borrower. Community banks, by their very nature, are closer to the economic realities of their markets and the credit worthiness of their borrowers. Risk monitoring tools deemed reasonable for the larger institutions may not be feasible, valuable, or necessary for the smaller institutions. Simply put, one-size-fits-all regulations do not serve the best interests of the financial system or local economies. We agree with the principles advanced by the guidance, but believe that any problems that arise in this area should be addressed through the supervisory process on an institution-by-institution basis.

Like the Basel II NPR, the CRE guidance could impair competition in the banking industry. Conceivably, banks may be led to leave the commercial real estate lending market and shift to a business line in which they lack expertise. Diversion of bank resources into other lines could have negative effects on competition in even the lowest-risk segments of the CRE market and on the availability of CRE credit in local markets. CSBS is concerned the CRE proposed guidance will lead banks to determine they have little choice but to rethink the manner in which they serve their communities, impacting community reinvestment, small business lending, and community revitalization programs. Regulatory guidance should not chase banks from a business line where they understand the market and risks, to a business line in which they lack expertise. This does not promote safety and soundness or competition in the industry.

Finally, CSBS is concerned with the thresholds that will be used to determine if an institution has a high CRE concentration in its portfolio. As you are aware, an institution would be urged to adopt the proposed guidance if its construction loans represent 100% of



the institution's total capital or if multifamily and nonfarm nonresidential loans and construction loans represent 300% of total capital. We do not believe the federal agencies have justified these particular thresholds. Also, it is our belief that if this guidance is implemented, examiners in the field and the industry may interpret these thresholds as limits. Therefore, in practice, the thresholds will effectively cap an institution's involvement in these lending areas. This unintended consequence will result in punishing small institutions that rely heavily upon CRE lending and effectively manage the risks of their portfolio.

The implementation of either the Basel II NPR or the proposed CRE guidance will impact the financial system in the United States. It is absolutely vital that the systemic impact of one or both of these proposals does not result in damage to our local economies. In order to support the economic vitality of our communities, we must first preserve the overall level of capital in the financial system. Sufficient capital is required to maintain institutional safety and soundness and economic stability. The dual-banking system must also be preserved by encouraging competition among institutions. Applying one-size-fits-all regulations will provide insurmountable obstacles to community banks struggling to compete with larger institutions. It is the goal of the Conference of State Bank Supervisors to preserve the economic vigor of the local communities we serve. I believe we share that goal with every member of this Subcommittee.

Therefore, it is critical that state regulators are finally given a full role in the regulatory process to ensure that the states are heard as proposals such as Basel II and the CRE guidance are initially discussed, debated, drafted, and adopted.

I commend you, Chairman Bachus, Ranking Member Sanders, and the distinguished members of this Subcommittee for addressing these matters. On behalf of CSBS, I thank you for this opportunity to testify, and I look forward to any questions that you may have.