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Statement

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John Reich, Director
Office of Thrift Supervision

concerning the

New Basel Capital Accord

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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Testimony on the New Basel Capital Accord
by Office of Thrift Supervision Director John M. Reich
before the
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I. Introduction

Good morning, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. 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 to update you on risk-based capital modernization in the U.S.

When I testified before this Committee nearly a year ago, I discussed my views on the development of the Basel II framework as of November 2005. I expressed concern about what we had just learned from the quantitative impact study, QIS-4. In particular, I noted that if we applied the emerging U.S. Basel II standard to the portfolios of some of our largest banks, there could be a potentially significant drop in their capital levels and a wide dispersion of capital requirements between banks. I also stated that even beyond these concerns, we had yet to resolve difficult policy issues in the modernization of our risk-based capital standards.

With the publication this week of a Notice of Proposed Rulemaking (NPR), I believe the Federal Banking Agencies (FBAs) have made progress since last year. First, we have to view QIS-4 as a preliminary study in the sense that the participating banks did not have the benefit of viewing the proposed rule. Therefore, I am pleased to say now that the FBAs have made numerous changes to the framework since the last version was published in the form of an Advanced Notice of Proposed Rule back in 2003. These changes should address many of the concerns with QIS-4. I believe the additional prudential safeguards that have been added to the

framework should go a long way toward ensuring the safety and soundness of Basel II in the United States.

I am also pleased that, in addition to the models-based approach of Basel II (the Advanced Internal Ratings-Based or A-IRB approach), the NPR includes questions aimed at eliciting comment on non-models-based approaches, commonly known as "standardized" approaches. Challenging policy issues remain, but the FBAs remain committed to resolve these issues and we look forward to receiving fully developed comments to guide us in this process.

II. Basel II – Models-Based Approach

The centerpiece of effective bank regulation is ensuring capital adequacy. Capital protects a banking organization from the risk of unexpected loss. Adequate capital is generally maintained through two different measures, risk-based capital to adjust capital adequacy by asset class based on risk, and a leverage ratio, which provides a baseline that is measured against an institution's balance sheet and that serves as an institution-wide capital floor. When banks took less complicated risks, our risk-based capital system was appropriately less complex. As our banking system evolved and banking risk grew more complex, our risk-based capital system has evolved to capture these risks. Today, at least for our largest banking organizations, the NPR represents a further refinement at capturing those increasingly complex portfolios of risk. This approach, in concept, attempts to be consistent with on-going efforts by the large, sophisticated banking organizations (worldwide) to measure risk quantitatively for their own economic capital purposes.

A few weeks ago, in my capacity as a member of the FDIC Board, I voted in favor of publishing the NPR proposal that, if finalized, would implement the Basel II advanced capital framework in the United States. The Basel II advanced approaches would apply to the largest and internationally active U.S. banking organizations and certain other banking organizations that opt-in to the framework. The publication of the NPR represents the culmination of a multi-year effort by the FBAs. That work, in turn, was based on and was part of a collaborative international effort by banking supervisors from a number of countries.

The Basel II international capital framework holds the promise of an international competitive level playing field for banking organizations that operate in different countries around the world. It also holds promise of a more accurate system of bank capital based on risk. This is appealing to bank supervisors in the United States, as well as to U.S. banking organizations. At the same time, the Basel II advanced framework is extremely complex. It will be costly to implement and it presents a number of significant policy and operational hurdles. For these reasons, I view publication of the Basel II NPR, and the public comment process that follows, as an important opportunity for the FBAs to re-assess the type of capital framework or frameworks that are most appropriate for, at a minimum, the largest U.S. banking organizations.

Basel II is substantially more sophisticated than our existing U.S. risk-based capital rules, based on the earlier international capital accord known as Basel I. Even though our current rules have been amended numerous times since their inception some fifteen years ago, our current risk-based capital rules are part of a relatively rudimentary framework. This framework focuses on measuring risk exposure on an asset-by-asset basis and placing assets into simple, broadly defined risk buckets. For example, our current rules make no distinction between a well-underwritten commercial credit to a strong borrower and a relatively weak commercial credit to a weaker borrower. Both are assigned the same (100 percent) risk weight. Similarly, residential mortgages, which can vary widely in quality, are assigned either a 100 percent risk weight or, if prudently underwritten and meeting certain criteria, a 50 percent risk weight. Most 1-4 family residential mortgages receive 50 percent risk weight. Currently, even some of the lowest risk residential mortgages are subject to a 50 percent risk weight floor; whereas the highest risk residential mortgages are subject to a 100 percent risk weight.

Basel II introduces into the United States a new mathematical models-based system designed to measure regulatory risk-based capital adequacy and improve risk management for our largest banking organizations. Basel II requires institutions to maintain and analyze data and to assess risk among different loan types. It requires assigning estimates of probability of default on individual loans and groups of loans, as well as loss-given-default, exposure-at-default, and,

where relevant, maturity. Basel II seeks to promote ongoing improvements in risk assessment capabilities; incorporates advances in risk measurement and management practices; and attempts to assess regulatory risk-based 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.

There are several issues raised in the NPR for which public comments are particularly important to assist the FBAs in navigating the best course for this rulemaking. These include whether the NPR achieves its primary objective of capturing the risks embedded in the largest and most internationally active banking organizations in a reasonably 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 as well as to encourage some creative thinking about non-models based standardized approaches. With the addition of various prudential safeguards, the FBAs have made significant efforts to address the concerns and issues raised by the results of the QIS-4 data collection. These safeguards included:

- 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. Starting in 2008, there will be a parallel run of the Basel I and the Basel II frameworks together for participating institutions. 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 a potential decline in each Basel II institution's risk-based capital would be limited by a series of graduated floors. 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 of the application of the framework. [1]

- Based on information received throughout the implementation process, the FBAs will continually evaluate the effectiveness of the Basel II-based capital rules. In fact, the FBAs anticipate the possibility of further revisions to the Basel II rules prior to the termination of the floors.
- Existing Prompt Corrective Action (PCA) and leverage capital ratio requirements will remain in effect throughout the implementation period.
- If aggregate industry capital falls by more than 10 percent, the FBAs may elect to recalibrate the framework, or revisit the formulas contained in the A-IRB and modify them, as necessary.
- Loss Given Default (LGD), a crucial input into the Basel II formulas, must be calculated based on appropriate stress scenarios (periods where an asset category demonstrates relatively high risk of loss), but only after approval of the primary supervisor. Alternatively, LGD may be calculated according to a conservative formula set forth in the proposal.
- In addition, the proposal includes a credit risk multiplier that limits the reduction in risk-weighted assets, essentially taking model results and multiplying them by a fractional safety factor.

In the near future the FBAs anticipate issuing proposed guidance and standards for implementation of the Basel II advanced framework. The FBAs also anticipate guidance that would implement Pillar II of Basel II, in particular to address the expectations in Basel II for an institution to perform its own internal capital adequacy assessment. Furthermore, the FBAs

[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. That reduction would be limited to a 90 percent floor in the second year (2010) and an 85 percent floor in the third year (2011). Each year, an institution's primary federal regulator will assess an institution's readiness to operate under the graduated floors, as well as on the potential termination of the floors for the institution after 2011.

anticipate issuing proposed reporting templates intended to provide greater transparency and consistency to the Basel II capital calculations of the participating banks.

The FBAs are currently working toward issuance of a final Basel II rule in 2007. Ideally, the timetable will provide U.S. institutions sufficient lead-time to prepare for a 2008 parallel run. However, with a comment period now extending into late January 2007, even that delayed target start date may prove ambitious. The FBAs are committed to getting this right. We expect extensive comment, and we know we still have a great deal of work to do. Further rulemakings may also be necessary to refine the Basel II framework. [2]

III. A Standardized Approach

As we develop a more sophisticated risk-based capital framework, it is important that we also consider what is identified internationally as the "Standardized Approach" – the less complex, non-models-based alternative to the Basel II A-IRB models-based approach. The Basel II NPR requests comment on this alternative. I believe it is important for the FBAs to consider whether the Standardized Approach or some variation of it could achieve many of the same goals as the models-based approach at a lower cost and with greater clarity and transparency. I also think it is important to note that, even within the context of that approach as it is being adopted in other countries, there is a carve-out for different capital treatment for reasons of national discretion.

Given the importance of this proposal and the wide range of views already expressed on different risk-based capital options, I anticipate commenters may go beyond the "Standardized Approach" as written (and developed primarily for banks in other countries without significant

[2] The 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 were submitted to the Office of Management and Budget for review prior to publication of the NPR.

input by the U.S. FBAs). I expect comments that may offer other options, perhaps similar to that standardized approach, but adapted creatively and appropriately to the U.S. banking system.

IV. Basel IA

While Basel II primarily applies to the largest internationally active U.S. banks, its implementation affects all U.S. banking organizations. This is due to the importance of competitive equity among U.S. banking organizations, both large and small. It would be unfair and poor public policy to impose dramatically different capital requirements for the same lending activities posing the same risk, simply because of the size and sophistication of the lending institution. In addition, there is an ongoing need to modernize risk-based capital for all of our banking organizations. To address competitive equity and to modernize capital rules, last year the FBAs issued an Advance Notice of Proposed Rulemaking (ANPR) soliciting comment on modernizing the existing Basel I-based rules. We refer to this effort as "Basel IA".

OTS was an early advocate of comprehensively revising and modernizing our Basel I-based capital requirements. 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 should improve the risk sensitivity of the current capital framework without unduly burdening affected institutions. Current risk weight categories (or buckets) are 0, 20, 50, 100 and 200 percent, but possible new and additional categories for consideration are 10, 35, 75, and 150 percent.

In addition to more risk buckets, applying commonly used risk criteria for identifying different levels of risk will further enhance our capital rules. For example, loan-to-value ratios, borrower credit assessments, and other broad measures, commonly used by banks of all sizes, could be incorporated into a risk-based capital system that differentiates and assigns risk-weights for some assets, such as 1-4 family residential mortgages. That is the type of increased risk sensitivity without undue burden that could move our risk-based system forward and better

allocate capital based on risk. Potentially, such a practical system should mitigate competitive inequity among banks of any size.

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 already indicated they prefer to continue operating under their current Basel I-based 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. For that reason, I believe Basel IA should be an optional framework, along with banks having the option to remain in the current Basel I-based system. The FBAs anticipate issuing the Basel 1A NPR within the next month. When we do, I expect and encourage additional comment from banking organizations of all sizes on the risk sensitivity and utility of the Basel 1A proposed changes, and on the flexibility of this system operating parallel with Basel I and Basel II-based standards.

V. Public Policy Concerns with Basel II and Basel IA

Longstanding and successful regulatory risk-based 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 this system. The OTS accepts the proposition that complex banking organizations undertake complex risks. I am hopeful that those risks can be captured by the Basel II proposal(s), and in a reasonably clear and transparent manner. Throughout the comment process and thereafter, we will work with the other FBAs towards that public policy outcome.

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. Recognizing that the U.S. banking system is remarkably diverse with a broad spectrum in size and type of banking organization, each set of capital standards we establish requires some reconciliation with the others. It is fundamental to fairness and capital neutrality that we maintain comparable (not necessarily identical) risk-based capital requirements for lending activities that have approximately the same risk characteristics, regardless of the lender.

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 a leverage ratio and risk-based capital. Along with other prudential safeguards, leverage is an important capital buffer. The OTS remains committed to maintaining an appropriate leverage ratio both throughout the implementation period of Basel II and beyond.

VI. Conclusion

OTS supports the goals of Basel II and we are committed to working with the FBAs to implement an effective risk-sensitive capital framework for all our banking organizations. We look forward to continuing the dialogue on Basel II and the parallel implementation of a Basel IA rulemaking. The Basel II NPR seeks comment on the standardized non-models based capital approaches as well as the advanced models-based approach. We will continue to work with the

Committee, the industry 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. Thank you.