TESTIMONY OF

DIANA L. TAYLOR

SUPERINTENDENT, NEW YORK STATE BANKING DEPARTMENT

On Behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

AN UPDATE ON THE NEW BASEL CAPITAL ACCORD

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

September 26, 2006

Room 538, Dirksen Senate Office Building

Introduction

Good morning, Chairman Shelby, Ranking Member Sarbanes, and distinguished members of the Committee. My name is Diana L. Taylor, and I serve as the Superintendent of Banks for the state of New York. I am pleased to testify today on behalf of the Conference of State Bank Supervisors (CSBS). Thank you for inviting CSBS to discuss the New Basel Capital Accord, which is commonly referred to as Basel II.

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. I am pleased to be here today with my fellow banking regulators to discuss Basel II, a proposal that when enacted could have a profound effect upon the financial system in the United States.

The financial markets have changed quite drastically in the 10 years since the implementation of Basel I. They are more sophisticated, with many new products and types of financial instruments available, and it was becoming increasingly clear to the regulators that it would be necessary to update the methodologies used, thus Basel II was born. At this point, I think it is worthwhile to reflect upon the Basel Committee's original objectives for the New Basel Capital Accord that would come to be known as Basel II. Those objectives, outlined in June 1999, were as follows:

- The Accord should continue to promote safety and soundness in the financial system;
- The Accord should continue to enhance competitive equity;

- The Accord should constitute a more comprehensive approach for addressing risks; and
- The Accord should focus on internationally active banks, although its underlying principles should be suitable for application to banks of varying levels of complexity and sophistication.

As the U.S. version of Basel II has evolved, through the federal agencies' Advanced Notice of Proposed Rulemaking (ANPR) and now Notice of Proposed Rulemaking (NPR), I have become increasingly about regulations for Basel II banks and the effect they might have on the competitive balance of our domestic banking system and state supervision. Currently, ten states, including my home state of New York, 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, but all states will be indirectly affected by its implementation. There clearly are potential domestic implications that could affect our banking system and our economy. Specifically, we must understand the impact of these regulations on safety and soundness and competitive equity. I am aware of the criticism of the so-called "conservatism" of the U.S. approach to Basel II and the concern about international competitiveness. Is this what Basel II has become? I do not believe we should be basing competitive equity on reduced capital. While our internationally active banks should be competitive, our first priority must be preserving the safety and soundness of the system and then ensuring a level playing field for our domestic institutions.

A major concern of mine as a state banking supervisor, is that if Basel II goes into effect as currently constructed, the result could be the further erosion of the dual banking system and our nation's broad and diverse financial industry. The dual banking system in the United States is unique to the rest of the industrialized world. We have thousands of institutions chartered by all 50 states. This difference has been our strength. It is widely accepted that community and regional banks play an invaluable role in our nation's economy. They are the foundation of our small business infrastructure and essential to the specialized lending needs of small businesses. The changes that would be implemented by Basel II must be well understood and must not have unintended consequences that may prove harmful to our valuable banking infrastructure.

Support the Need for Basel II

CSBS remains fully supportive of the goal of Basel II: to better align regulatory capital requirements to underlying risks, and to provide incentives to banks to hold lower-risk assets in their portfolios. I believe planning for Basel II has led to several positive results. Risk management has improved at our largest banks and important data collection and modeling efforts have taken place. Supervisors and the industry now have an increased understanding of credit risk and operational risk, and data collection efforts—of characteristics of operational risk events, classification of credit losses, and differentiation of losses during economic downturns—have begun that will be extremely valuable in the years ahead. Supervisors have gained a greater understanding of bank portfolios, and we have had productive interactions with supervisors from other countries. The benchmarking exercises and data collection efforts carried out for Basel II implementation will be essential for validation and model review at Basel II banks.

CONCERNS FROM THE STATE PERSPECTIVE

Potential Drop in Capital

Before we decide to move ahead with implementation of Basel II's Advanced Approaches, however, I believe we need to address a number of important issues. The results of the fourth Quantitative Impact Study (QIS 4) in the U.S. showed drastic drops in required capital. 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, it is unlikely that this trend will continue uninterrupted forever.

I am sure each of you is well aware of the benefits that are added to your states by healthy, well-capitalized banks of all sizes and the role that a small bank plays in a local economy cannot be overestimated. As a state supervisor, I am very concerned with the disruption that would be caused by a small bank ceasing to operate 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. Therefore, it is our responsibility to ensure that changes in capital requirements are prudent, do not unduly benefit one type of bank over anther and that any transition to a new calculation of capital is carefully managed.

Impact on Domestic Competition

Research by Federal Reserve staff[1] suggests that adoption of Basel II as described in the NPR could have adverse impacts, particularly for large regional banks. In the Basel II White Paper, "An Analysis of the Potential Competitive Impacts of Basel II Capital Standards on U.S. Mortgage Rates and Mortgage Securitization," by Hancock, Lehnert, Passmore, and Sherlund and released in April 2005, the authors find a potential competitive advantage for banks that adopt the Advanced Approaches of Basel II, but point to securitization practices and uniform pricing within market segments as reducing this advantage.

Hancock et al describe the advantage the Advanced Approach adopters will have as the power to pressure the GSEs on the price of guarantees, since the banks' capital requirements may well be lower than GSE capital requirements. They assert that uniform pricing in all market segments will reduce any impact from the Advanced Approach banks' greatly reduced capital requirements. They also estimate that as of Q3 2003, 36% of loans outstanding in the U.S. were not securitized – these are the loans that end up in bank portfolios, and will be subject to capital requirements. Banks' ability to compete in loan origination is affected by their ability to securitize loans, and the largest banks have an advantage already because they are packagers of loans for securitizations themselves. The potential pressure on GSE pricing identified by the Federal Reserve researchers should be explored further, as a change in GSE pricing would affect all banks and have wide market implications. Also, it is not clear that uniform pricing would hold if the capital requirements for Advanced Approach banks declined significantly.

[1] Source: http://www.federalreserve.gov/generalinfo/basel2/whitepapers.htm.

Banks that adopt the Advanced Approaches for Basel II could have a substantial pricing advantage for loans that banks don't securitize –including nonconforming Alt-A or jumbo loans, prime ARMs, low-doc loans, and subprime loans. Banking regulators have released guidance concerning these and alternative mortgage products, and should now make sure that risk-based capital treatment of these products is consistent with their safety and soundness guidelines. As we move toward implementation of new capital requirements, it is important that we continue research concerning banks' mortgage portfolios.

Under the draft NPR, Advanced Approach banks would treat home equity loans very differently than banks that do not adopt the Advanced Approaches. According to the NPR, "first and subsequent liens, term loans, and revolving home equity lines of credit" are included in the retail portfolio as long as the borrower is an owner-occupier of the building, with an exception for buildings with few rental units. However, under both current capital requirements and Basel IA, home equity loans and junior liens are risk-weighted as residential real estate only if they meet certain stringent conditions and at 100% otherwise. Banks that do not adopt the Advanced Approaches could face competitive pressure for these products, and this should be addressed directly by the federal agencies.

Small business lending may also be adversely effected. In "Potential Competitive Effects of Basel II on Banks in SME Credit Markets in the United States,"[2] Allen N. Berger of the Board of Governors of the Federal Reserve System, found competitive advantages for banks adopting the Advanced Approaches of Basel II. Berger analyzed

[2] Source: http://www.federalreserve.gov/generalinfo/basel2/whitepapers.htm.

small business lending at U.S. banks as of Q2 2002, and discusses the differences in small business lending among commercial banks of four different asset sizes (top twenty banks by asset size, banks between $16 and $56 billion, banks between $1 and $16 billion, and banks between $1 million and $1 billion in asset size). He found that although there were differences in characteristics of small business lending between the top twenty banks and the smallest banks (those with assets between $1 million and $1 billion), there were not significant differences in small business lending between the top twenty banks and those with assets between $1 billion and $56 billion. Berger concludes that the top twenty banks – likely adopters of Basel II Advanced Approaches – could have a competitive advantage in originating the "safer" small business loans (those with lower PDs and LGDs) as far as all non-Advanced Approach banks are concerned, and that banks with assets over $1 billion could face significant competitive pressure from banks that adopt the Advanced Approaches.

The data banks submit on their small business lending for CRA disclosure reports is an important source of information about small business lending by U.S. banks. Additional important sources of small business loan information could be specific questions in the Federal Reserve quarterly Senior Loan Officer Opinion Survey on Bank Lending Practices combined with the quarterly Survey of Terms of Business Lending. These data should be studied to understand the market for small business lending in the U.S. In addition, the PDs and LGDs assigned to small business retail segmentation by Advanced Approach banks during the transition years should be tracked. These parameters estimate the relative riskiness of small business loans, and should be compared to small business lending experience at banks that don't adopt the Basel II Advanced Approaches.

Finally, it is important that we make sure Basel II does not provide incentives to the largest banks to increase their acquisition of smaller banks. We must understand to what extent imbalances in capital requirements for the same assets might make acquisition of smaller banks by Advanced Approach banks desirable. Regional and community banks bring important qualities to small business lending, they have local knowledge, their traditional underwriting may be more flexible than model-driven lending, and there are supervisory tools already in place for monitoring this lending. I would encourage all Basel II stakeholders to consider the JPMorgan report, "And the Big Shall Get Bigger….",[3] which concludes "Basel II should benefit larger, more sophisticated banks much more than smaller banks and may provide an extra catalyst for merger and acquisition given limitations around any sort of direct capital release."

Role of States in Rulemaking

In order to successfully implement regulations such as Basel II in the United States, I believe state supervisors must have a more substantive role in the drafting and implementation process. 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 are very appreciative of Governor Bies' willingness to provide regular briefings to state supervisors on the status of Basel II and Basel 1A. However, we believe it would be appropriate for state regulators, through CSBS, to have a seat at the table along

[3] "Basel II: And the big shall get bigger…." JPMorgan European Corporate Research, J.P. Morgan Securities Ltd., London, September 15, 2005.

with our fellow regulators when rules that affect our institutions to such a great degree are being considered.

Additionally, the Basel II NPR 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 New York, that charter potential Basel II banks. For these banks, the state is their primary regulator. 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. The draft NPR for reporting public and confidential data limits access to the confidential data to the Federal banking agencies. The NPR states the agencies will use the data to:

• Assess the components of each bank's risk-based capital requirements;

• Assess each bank's capital relative to inherent risks and the agencies' minimum capital requirements;

• Monitor the levels and components of the risk-based capital requirements for banks through peer, outlier, and risk trend analyses;

• Evaluate the quantitative impact and competitive implications of the implementation of the Advanced Capital Adequacy Framework on risk-based capital levels within reporting banks and on an overall industry basis;

• Provide market participants, depositors, the public, supervisors, and other interested parties with information about banks' risk-based capital; and

• Supplement on-site examination processes and decisions pertaining to the allocation of supervisory resources.

The agencies are absolutely correct in their stated need and planned use for this data. State supervisors share this interest in fulfilling their supervisory responsibilities and broader responsibility for the state banking system.

To further this point, in a 1997 speech before CSBS, former Federal Reserve Chairman Alan Greenspan credited the large number of community banking institutions in the U.S. as being the key "to the stability of the banking system and the well-being of the macro-economy." He went on to add, "…Just as large numbers of smaller banks are a key to the robustness of our economy, the state charter is a key to the robustness of our banking structure…." Moreover, Chairman Greenspan concluded that the decentralized nature of banking and bank supervision were "arguably the key to weathering the financial crisis of the late 1980's."

As we experienced in the 1980's, capital requirements are an essential cornerstone of bank regulation and if the states are excluded from decisions affecting this critical regulatory tool, a major strength of our diversified system identified by Chairman Greenspan is lost. Centralized power and decision making may be easier, but in the U.S. banking system, it has not proven to be better.

Addressing Basel II Concerns

CSBS is 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." We commend FDIC Chairman Bair for initiating a dialogue on the need for an international leverage ratio. This would be a significant step to strengthening the international banking system.

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.

We propose that the federal agencies—working with state banking supervisors—release reports during this period describing the progress of Advanced Approach banks (based perhaps on the proposed federal regulatory reporting forms) and the results of Advanced Approach benchmarking and model validation exercises. These reports will allow us all to gauge the effectiveness and possible consequences of the Basel II revisions.

U.S. banking regulators should also publish detailed plans describing how they will assess levels of required capital across the system once revised capital regulations are released. Moving forward with revised capital regulations will be much easier if bankers and supervisors understand the methods for assessing changes in the level of capital. This assessment should cover the entire banking system and should include a study of the areas where required capital either increases or decreases, by portfolio, institution type, region, and local community.

We now have the opportunity and the responsibility to make sure that when Basel II is implemented in the United States it will meet the objectives first put forth in 1999. I propose that we consider simpler Basel II options until we better understand the consequences of adopting Basel II's Advanced Approaches. We still do not know if Basel II will be successful in significantly reducing capital arbitrage. Basel II is an elaborate and complex set of regulations, and we are simply not far enough along to truly understand the exact nature of its incentives and motivations. It is my belief, however, that capital arbitrage will not only continue, but will itself increase in complexity and become more difficult to monitor and supervise.

The Standardized Approach

Recently, CSBS requested that the federal agencies seek public comment on offering the Standardized Approach in the United States. The agencies have included such a question in the Basel II NPR, and we commend them for doing so.

Several of the core Basel II banks have complained about details of the U.S. implementation of Basel II, and requested that they be allowed to follow the Standardized Approach. The arguments against allowing these banks to follow this approach seem to be (a) this approach is not appropriate for U.S. mandatory banks and comparable banks in other countries are not utilizing the Standardized Approach; and (b) U.S. regulators have not performed the work necessary to implement the Standardized Approach.

We are aware, however, of several comparable foreign banks that are considering following the Standardized Approach for credit risk. It is our belief that the Advanced Approaches are not being adopted uniquely in any other country. The United States appears to be the only nation that refuses to allow institutions to adopt the Standardized Approach.

Also, I believe it would be feasible for U.S. banking agencies, working in conjunction with the states, to produce estimates of the effect of the Standardized Approach across the country. The Basel Committee and other countries, such as Germany, have performed studies of the Standardized Approach and made their results available. In addition, much of the work the federal banking agencies have carried out to develop Basel IA could be used in drafting a U.S. implementation of the Standardized Approach.

In my opinion, it is possible that adopting the Standardized Approach could allow us to increase the risk sensitivity and comprehensiveness of current risk-based capital requirements and establish uniform capital requirements across all institutions, which were original objectives of the Basel II framework put forth in 1999. The Standardized Approach could capture more off-balance sheet risk than current capital requirements, thereby offering a superior complement to the leverage ratio. Also, the Standardized Approach does not call for enormous expenditures by banks, and can be supervised by examiners without relying unduly on bank staff.

It is important to remember that the Standardized Approach is part of the original Basel framework. This is not a novel or surprising aspect of Basel II. In my opinion, if a regulation can be simplified, it should be. Our domestic financial system could benefit from a less complex, more risk sensitive approach to monitor risk-based capital requirements.

The End Game of Basel II

Despite its current complexities, the original purpose of Basel II was really quite simple. Ultimately, the intention of Basel II is to produce a stronger international system that does not weaken our domestic dual banking system. In our rush to improve safety and soundness and competitive equity in the international system, we absolutely can not afford to weaken safety and soundness and competitive equity in our own domestic institutions. As U.S. regulators, our first priority must be to our domestic institutions.

The objectives of Basel II outlined in June 1999 must be met as we implement Basel II in the coming years. As regulators and legislators, it is our duty to ensure that the Basel II framework, including both the Advanced and Standardized Approaches, promotes safety and soundness, enhances competitive equity, provides a comprehensive approach for addressing risks, and embodies principles that are applicable to banks of varying sizes and levels of complexity. Most importantly, we must not diminish the dual banking system which has served our citizens and economy so well.

I commend you Chairman Shelby, Ranking Member Sarbanes, and the distinguished members of the Committee for addressing this matter. On behalf of CSBS, I thank you for this opportunity to testify, and I look forward to any questions that you may have.