A REVIEW OF REGULATORY PROPOSALS ON BASEL CAPITAL AND COMMERCIAL REAL ESTATE

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

SEPTEMBER 14, 2006

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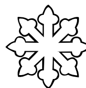

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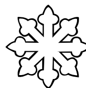

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A REVIEW OF REGULATORY PROPOSALS ON BASEL CAPITAL AND COMMERCIAL REAL ESTATE

Thursday, September 14, 2006

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 11:03 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the subcommittee] presiding.

Present: Representatives Bachus, Royce, Kelly, Feeney, Hensarling, Garrett, Price, McHenry; Sanders, Maloney, Sherman, Moore of Kansas, Frank, Carson, and Crowley.

Chairman BACHUS. Good morning.

The Subcommittee on Financial Institutions and Consumer Credit holds its sixth hearing today on Basel reform since the 106th Congress.

Today's hearing will focus on the current status, recent developments, and potential impact of proposals from the financial regulators on Basel capital reform and commercial real estate lending guidance.

All of the regulators have worked hard to develop the proposals we will be discussing.

Governor Susan Bies deserves special appreciation for her dedication and leadership on the Basel accord.

Governor Bies has created an open dialogue with Members of Congress and the financial services industry. She understands the concerns that members of this committee have raised with past proposals, and has worked diligently to address those issues.

To the other agencies and regulators, let me say this, I very much applaud your efforts. I think you've been very responsive to the industry.

There's not a consensus among the regulators. There are still some important differences. But we're so far away from where we were last year, and we're very, very close, and I applaud all of you.

I was pleased this month when the regulators met and approved the notice of proposed rulemaking on Basel II that requested comment on whether the so-called core banks and opt-in banks should be able to use the standardized approach.

Alternative compliance options are a feature of the original accord, and banks outside the United States are provided this option.

I've lost a page of my opening statement. Actually, this isn't the one I wrote. This was an early one. We'll try to find it.

Well, I tell you what I'm going to do. I'm going to let Mr. Sanders give his opening statement, and I'm going to come back.

Mr. Sanders.

Mr. SANDERS. I haven't lost my paper. I still have it.

Mr. Chairman, thank you for holding this important hearing, and I look forward to hearing from our witnesses.

In the interest of time, I'll make my remarks very brief, and then hand the ranking member responsibilities over to Ms. Maloney, who has worked on this issue for a number of years.

This hearing will review both the recent Basel II and commercial real estate proposals put forward by the ranking regulators.

This subcommittee has held several hearings on the Basel capital accords, and I would like to applaud the chairman, Ranking Member Frank, Ms. Maloney, and others for their leadership on this issue.

The Basel accords determine the process by which banks determine the capital they must hold in reserve to meet regulatory requirements.

The Basel II accords apply to the 10 largest banks, while the Basel I accords apply to the smaller banks.

In my opinion, it is extremely important that big banks are not given an unfair advantage over smaller banks in this process, and I'm not convinced that has happened to date.

Mr. Chairman, I'd like to ask for unanimous consent to insert into the record a statement by the National Association of Realtors.

Chairman BACHUS. Without objection.

Mr. SANDERS. Mr. Chairman, I share the concerns of the National Association of Realtors that both the proposed regulations and the proposed guidance on commercial real estate lending underestimate the strength and stability of the commercial real estate market and do not sufficiently recognize the diverse performance traits of the different classes of commercial real estate.

The combined effect of these two regulatory proposals may prompt banks either to avoid making loans for sound real estate ventures or to increase the cost of capital required for commercial real estate.

I am also concerned that if the regulatory parameters are not appropriately set, the flow of capital to commercial real estate would be diminished, leading to a weakening of the commercial real estate market. Mr. Chairman, we must not allow that to happen.

We must ensure that the final guidelines on commercial real estate, risk management guidelines, preserve and strengthen the safety and soundness of the banking system while not unduly harming the flow of capital to commercial real estate.

Again, I thank the Chair for holding this hearing and I look forward to hearing from our witnesses.

Mr. Chairman, is it appropriate to give the microphone over to Ms. Maloney for a few words at this point? Can I yield to Ms. Maloney to complete my statement?

Chairman BACHUS. Actually, I'm going to recognize—oh, for part of your time?

Mr. SANDERS. Yes.

Chairman BACHUS. Okay.

Mrs. MALONEY. Thank you, Mr. Chairman, Ranking Member Sanders, and Ranking Member Frank.

I first would like to welcome all of the witnesses, particularly one who is a constituent from my district, Mr. James Garnett of Citibank, who is testifying today on behalf of the Financial Services Roundtable.

As a representative from New York, the financial capital of the Nation, I have been deeply interested in the development of the Basel II capital accord since its inception.

The concept of adjusting capital requirements to reflect risk more accurately than the present regulatory system does is a tremendous opportunity for the American financial services industry and for the U.S. financial regulatory regime, but also it is a great risk.

The process of financial services regulation in this country is more complex and involves many more players than in most nations, with different agendas and powers, and our regulatory system is by far the most robust in the world.

We have a more diverse and multi-faceted industry in many nations with different needs and concerns.

As I have said at many stages of this process, if we are not careful, these factors can drive us to a new regulatory scheme that disadvantages our financial services industry rather than making it more competitive, while not improving safety and soundness.

We can end up with a situation in which the new capital requirements provide incentives to increase, rather than reduce, risk, and thus threaten the safety and soundness of the system.

Congress is certainly not well-equipped to legislate a regulatory scheme of this complexity, but it is our job to guide regulators toward policy goals.

Our goals are the same as those of the Basel Committee, to continue to promote safety and soundness while enhancing competitive equity and instituting a more comprehensive approach to evaluating and addressing risk.

I have to say that I am not confident that the present proposal is well designed to achieve that end.

As I am sure we will hear from the industry witnesses, financial institutions, even the biggest ones who are up now, have been presumed to be the biggest beneficiaries of the new rules. Many are very apprehensive that the new rule will leave them at a significant disadvantage as compared to foreign financial institutions.

The regulators have taken the position that the revised formulas are necessary to maintain overall capital in the system and respond to the concerns raised by the results of the last quantitative impact study, the QIS.

I am sure that the regulators also want a competitive U.S. industry, but they do not appear to have the confidence of their industry, and they have put our banks in as good a position as those of other nations.

One point that I hope the witnesses address is the apparent gap, the gap between the practices mandated by the proposed U.S. rules to measure risk and those used by the financial institutions at present.

Large banks already have very complicated and sophisticated internal risk models and risk management systems, all subject to oversight.

According to some of the financial institutions I've talked to, the proposed U.S. rules mandate systems that are so different that banks will have to keep literally two sets of books, one to measure what the regulators want to know about risk, and one to measure what the banks think they know to do the job.

As a policymaker, this is deeply disturbing, since it suggests that either the markets or the regulators are missing the boat and measuring irrelevant variables.

I also hope the witnesses will address the cost of compliance and the return in terms of better risk management. We cannot institute a system that is not cost effective because it will unnecessarily hamper our financial institutions and make them uncompetitive in the global market.

Chairman BACHUS. Ms. Maloney.

Mrs. MALONEY. I have a lot more to say, but I'll put it in the record.

Chairman BACHUS. Thank you.

Mr. Frank.

Mr. FRANK. Thank you, Mr. Chairman.

I appreciate our having the chance to talk about both of these events.

Let me start on the question of Basel, and I appreciate Governor Bies's diligence in working with us.

You know, there is a view that says that when Congress intervenes in something, particularly if it is complicated and technical, we either muck it up or corrupt it, that we are either looking to benefit some undeserving group or we will get in over our heads; and that is not always untrue, but neither is it true as often as people say, and I really want to hold up the Basel issue as an example of an extremely constructive Congressional intervention.

I believe that the result of the process we've had, it's been conversations back and forth. I think we have a better proposal. We are still working on it.

I think, frankly, we were the catalyst for there being better cooperation among the regulators. I think we had a situation when we first got into this where the relationships among the regulators were dysfunctional and I think our impact has been helpful.

And so I want to say that I think this is a case, on a bipartisan basis, where we have played a constructive role. Of course, since it has been both bipartisan and constructive, it is rarely chronicled, and so that is why I thought it was worth underlining.

I will say to the regulators, particularly to the Federal Reserve, which has had a major initiative, I am skeptical of the resistance to the notion about the standardized approaches.

You know, sometimes, when all the people in industry get together, you get nervous. As Adam Smith said, when all the people in the same trade get together, you have reason to worry.

In this case, I think the consensus that has emerged among the banks is a constructive and helpful thing. This is not a case of the banks versus the public interest. It's not a case of the banks versus the consumers or the banks versus the securities.

In this situation, I don't think we have the concern that this is a group of people who have a common economic interest in contradistinction to others in the society, and in fact, as we all know, many of the problems we had were the differential impact that capital standards could have within the banking industry.

I am impressed by this consensus. I congratulate the people in the banking industry for a very responsible effort to come together on this, and I would say to the regulators, this is a case where, in my mind, the burden of proof is on those who would say, "No, that's not going to work given the commonality of interest."

The next area is the real estate guidance.

First of all, I have to say I don't mean to impugn motives. We're not talking about personal stuff here. But I think it would be disingenuous for the regulators to say, "Oh, this doesn't have any real impact, this is just kind of generalized guidance."

In the first place, when someone says to me, "Oh, listen, you know, I just want to point out to you that being extremely badly dressed is a great defect in your business, and having clothes that are ragged and dirty and mismatched, you know, that is something that you certainly don't want to fall into, oh, and by the way, nothing in what I said suggests that you're at all guilty of this or that you have to change your pattern"—no one would believe anybody who said that.

I mean, there are a lot of things in the world to say, and the very fact of singling something out to say it has a great impact, particularly, frankly, when you are you, the regulators. You are enormously powerful people with great impact.

And so I think we have to begin by saying the fact that you have singled out this kind of real estate lending for guidance, I mean, whenever someone says to me, "Oh, by the way, I want to tell you not to be stupid and not to be dangerous, but please don't be offended," I'm offended, because the fact that you felt the need to tell me not to be stupid doesn't make me think you think I'm all that bright. So let's be clear about that.

I am therefore worried, because, yes, I understand that there is an increase in the lending, but by your own figures, there is no increase in risky lending. There does not appear to be a problem.

And there is a negative side to this. Clearly, if I am a bank, I would rather not have you give me explicit guidance on something. That is not a good sign.

I have to say this to cover up my own staff. If I get a letter from somebody saying, "By the way, Congressman, I just would like to point out to you that it would not be a good idea for your staff to be rude or forgetful or make any enemies; by the way, nothing in this suggests"—I would call in the staff and say, "What is this? What happened? Who did what to whom?" I mean, anybody would do that.

So I am afraid you will discourage some of this, and there are two areas.

One, we work a lot with mayors and municipal officials. Downtown lending is very important for them, the commercial development, but even more for me, the fact that multi-family housing is included in here.

We have a terrible social crisis in America with housing that is far too expensive for a lot of working people. We have municipalities where police officers and firefighters and teachers and sanitation workers can't live in the city where they work.

I would hope that you would be extremely loathe to do anything that might diminish the construction of multi-family housing. We have too little of it in this country. We have local prejudices expressed through zoning that are problems, etc.

And I believe that you, by your guidance, you have really discouraged to some extent that kind of lending, and unless you've got a pretty good reason, the fact that there is more lending absent anything shouldn't be the reason, and at the very least—and I appreciate the time, Mr. Chairman, I'll close with this—you've already done that, you say to us, "Well, this doesn't mean they should cut back." Then I would hope that would be part of the official statement.

Everybody has gotten that guidance. You ought to write to them and say, "By the way, nothing in here suggests that you have done anything wrong, that you have been in any way imprudent, or that you should in any way be cutting back on this area."

That would at the very least reassure me. A failure to do that would reinforce my nervousness.

Thank you for the indulgence, Mr. Chairman.

Chairman BACHUS. Thank you, Mr. Frank.

Now I'm going to give the remainder of my opening statement. I want to apologize to the staff first for doing the impossible, and that's that I wrote out my speech, my second draft, in longhand, and I neglected to give it to them.

[Laughter]

Chairman BACHUS. So it was pretty impossible for them to include the additions.

The goal of Basel is to develop a more flexible and forward-looking capital adequacy framework that better reflects the risks facing banks and encourages them to make ongoing improvements to their risk assessment capabilities.

Over the past 7 years, the United States Federal banking regulators have been engaged in negotiations with their foreign counterparts about improving the standards that govern the capital that depository institutions must hold against their assets.

We must ensure throughout this process that we do not include a framework that is too complex or too costly to be followed.

There is a wide variety of views expressed in the testimony that we will receive today.

On one hand, the Federal banking regulators are testifying that they have developed a Basel II rule that is intended to produce risk-based capital requirements that are more risk-sensitive than the existing rules.

On the other hand, industry witnesses will testify that the current U.S. version of the Basel II rule is less risk-sensitive than the internationally negotiated Basel II accord and that the differences between the U.S. rule and the accord creates serious competitive issues, both within and outside the United States.

This suggests to me that more work needs to be done on the rule.

I was pleased this month that the regulators met and approved the notice of proposed rulemaking on Basel II that requested comment on whether the so-called core banks and opt-in banks should be able to use the standardized approach.

Alternative compliance options are a feature of the original accord and banks outside the United States are provided this option.

In addition to the issues arising from Basel II, our hearing today addresses a January 2006 interagency guidance on concentrations in commercial real estate proposal by the bank regulators. The proposal seeks to address high and increasing concentrations of commercial real estate loans at some banks and savings associations.

The agency suggests recent examinations show that risk management practices and capital levels of some institutions are not keeping pace with their increasing CRE loan concentrations.

In return, the guidance sets forth thresholds for assessing whether an institution has a CRE concentration that should employ heightened risk management practices. The guidance urges those institutions with elevated concentration risk to establish risk management practices and capital levels commensurate with the risk.

Some institutions have expressed the concern, however, that the proposed guidance is too much of a "one size fits all" formulation, and is effectively a cap on commercial real estate lending. They instead urge that the regulators utilize the examination process that identifies lending weaknesses in particular institutions.

They contend that the data does not support the proposition that real estate lending, per se, is more risky than commercial and industrial lending, for example.

Further, there is concern that the proposed guidance is unfairly burdensome for community banks that do not have opportunities to raise capital or diversify their portfolios like larger banks.

It is my hope that, by the end of this hearing, we may all be working for the same set of underlying facts with respect to how the real estate works. In turn, I would hope that this will help ensure better regulation that will protect the taxpayer while not arbitrarily discouraging sound lending.

In closing, I want to thank Chairman Oxley, Ranking Member Frank, and all of the members of the committee for their interest in working to ensure that we get Basel right.

I look forward to hearing from the witnesses today.

At this time, I recognize Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

First, let me thank you for holding this hearing. I frankly think it's one of the more important hearings that your committee could hold. It's a very, very tough issue that we have to deal with.

On the one hand, as somebody who represents a district in Texas, although I was not in Congress at the time, I still have a very firm memory of the late 1980's and early 1990's and the S&L meltdown, and how an over-concentration of real estate led to an incredible economic contraction and a massive taxpayer bailout. So my memory of that incident in American history is still quite clear.

On the other hand, today we're enjoying one of the best economies that we have enjoyed in America, with historically low unemployment rates, 5 million new jobs, we're awash in tax revenues, we've got the highest rate of home ownership we've had in the his-

tory of America, we have many other good and favorable signs, and a very good case can be made that real estate has helped lead to this economic boom.

So anything that would provide onerous burdens on further loans to commercial real estate concerns me, and as many on this panel know, and share with me, I have a concern about the future of community banking in America, which with the help of almost everybody on this committee, we put together what I believe is a very good regulatory relief bill that would be very significant for community banks.

But if we don't, if the regulators don't get it right, that burden is going to increase even further, and I am led to believe that this particular niche in the marketplace is a very, very important niche to their profitability and their survivability.

So I look forward to hearing from all the witnesses, but as always, I come into these hearings with a very strong bias in favor of free people and free markets, and I always put the burden of persuasion upon those who are proposing further restrictions upon loans and loan limits, and I look forward to hearing what compelling case might be made in this regard.

And again, Mr. Chairman, I thank you for holding this important hearing and I yield back.

Chairman BACHUS. Thank you, Mr. Hensarling.

Are there any other members who wish to make opening statements?

Ms. Kelly.

Ms. KELLY. I thank you, Chairman Bachus, for holding this hearing.

I, too have shared the interest in this committee in learning how the Basel II accords will impact our local communities.

Unfortunately, we now have the evidence that there is such evidence, and it's negative.

On January 10, 2006, an interagency guidance was issued regarding commercial real estate lending. This has been followed by weeks of reports from community banks that examiners are now questioning bank investments in their own communities that have never before raised any concern.

While there's a legitimate concern that banks not over-lend in any category, commercial real estate is a single name for a very broad range of activities. Everything from factories, hotels, golf courses to warehouses, office buildings, and parking lots is contained in the category of commercial real estate.

Unlike housing, which moves broadly to interest and employment rates regionally and nationwide, each class of commercial real estate responds differently, and to lump them together for the purpose of bank examination doesn't seem to make a whole lot of sense to me.

Community banks exist to serve their communities, to understand their needs, and to provide capital for worthwhile investment. By definition, they invest where their customers are. They invest also for the long term and have a very large stake in the success of their neighbors.

Unlike capital from large institutions, they provide a continuity which can often be the difference between the success or failure of a whole town or even a county.

To require an artificial diversification out of the communities that they serve doesn't really benefit them or the taxpayers.

The guidance issued by the banking agencies, if confirmed, I believe will eliminate the small bank as a viable institution. Commercial lending, like credit cards, home lending, and deposits will be dominated by large banks and conglomerate financial institutions.

I urge these witnesses that are going to be before us today to take a look at community banks and their portfolios as individual institutions rather than lumping them together just to save regulators time and effort.

I thank you and I yield back the balance of my time.

Chairman BACHUS. Thank you, Ms. Kelly.

Are there any other members? Mr. Price, did you have an opening statement? Okay. No other opening statements.

All right. At this time, I'd like to introduce the first panel, which needs no introduction.

Mr. Frank wanted to introduce Mr. Antonakes, but I'll introduce all of them, I think.

The first panel consists of: the Honorable Susan Bies, Governor, Board of Directors of the Federal Reserve System; the Honorable Sheila Bair, Chairman, Federal Deposit Insurance Corporation; the Honorable John C. Dugan, Comptroller, Office of the Comptroller of the Currency; the Honorable John Reich, Director of the Office of Thrift Supervision; Mr. Robert Colby, Acting Director, Division of Market Regulation at the SEC; and Mr. Steven L. Antonakes, commissioner, Massachusetts Division of Banks. And you're testifying on behalf of the Conference of State Bank Supervisors; is that correct? Okay.

We welcome all of the panelists and look forward to your opening statements. Thank you.

Governor Bies.

STATEMENT OF HON. SUSAN SCHMIDT BIES, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Ms. BIES. Thank you, Mr. Chairman. I want to thank you, Representative Sanders, and members of the subcommittee for this opportunity to join my colleagues to discuss both the recent developments in regulatory capital and our proposed guidance on sound risk management for commercial real estate.

Let me begin by just saying that the completion last week of the draft NPR for Basel II for comment reflects a lot of hard work across all of the agencies and active input from many constituencies, bankers and non-bankers, and Congress. We really appreciate all of the effort that people put in; I think all of us know it was important in achieving this milestone.

I want to make one comment before I get to Basel II, about the market risk amendment that was also put out for comment. This is an update of an old rule that we've had that deals with trading book risk, and this is applicable to all U.S. banks currently that have big trading book activity.

What's remarkable about this is that it's based on the framework that was jointly agreed to by the Basel Banking Committee and the International Association of Security Commissioners. What we're proposing here is both an update that reflects new risk-taking, but more importantly, will help to level the playing field between investment banks and commercial banks who are subject to the similar regulatory environment for capital. We've been working actively with the SEC and we appreciate their support on that; so we look forward to those comments, too.

Let me turn to Basel II. As you know, as we've been working through this, we have tried to emphasize not just the Pillar 1, which has gotten most of the attention, but also Pillars 2 and 3.

The Pillar 1 proposal that we have put together in this NPR proposes that only the most advanced organizations are required to adopt it, and it uses the most advanced approaches of the Basel 2004 Accord. I want to compare that to what you're hearing from other countries and what they're doing.

There's a difference here, because in other countries, when Basel II becomes effective, Basel I goes away. We've chosen, in the United States, to listen to the smaller community banks and to retain Basel I, which we are working to amend.

What this means is that since Basel II applies to all banks of all complexity and size globally in those countries, there are three general varieties of approaches to risk to reflect the differences in size and complexity of those organizations. Again, we in the United States have only focused on the most advanced approaches.

But it's also important to realize that Pillar 2 is very important in all of this, because it requires that an organization look beyond credit and operational risk to look broadly at their risk through the cycle, and make sure it agrees with their business strategy.

Finally, Pillar 3, which ensures additional disclosure, is important because it reflects that we want market discipline to differentiate risk.

We at the Federal Reserve have been consistently supporting the most advanced approaches because today's Basel I does not reflect the changes in risk for these big organizations; it doesn't reflect the operational risks that have led to a lot of publicly charged off events and some of the legal problems that banks have encountered that required chargeoffs; it doesn't reflect the fact that under Basel I a certain portfolio could have very different kinds of risk exposures across banks, and we think a bank who chooses to take on more risk of a certain type should hold more capital.

Finally, we've got the safeguards in the proposal, both in terms of parallel runs and transition periods, but we also have listened to comments, done analysis based on QIS studies, and strengthened elements in this NPR to deal with weaknesses that we've already identified, and we'll continue to do that as we move forward.

Finally, on commercial real estate. Commercial real estate has our concern. As a banker, I lived through the hard side of working through the southeast real estate problems in the 1980's. We know today that community and mid-size banks have exposure to commercial real estate relative to capital twice what it was in 1990.

What we intended in this guidance, since we don't have a lot of information on the call reports, is to indicate to our examiners that

they need to focus on the portfolio management of these banks, not just the individual loan underwriting, and that they need to begin a dialogue at the screen levels, which would not be ceilings.

And we do want our examiner to look at how the bank looks at the types of real estate loans they have, and how they monitor the markets, and to consider the broader aspects of portfolio concentration management which we find is not developing as quickly as banks increase their concentration in this line of business.

Thank you, Mr. Chairman, for your comments, and I'll wait for further questions.

[The prepared statement of Governor Bies can be found on page 96 of the appendix.]

Chairman BACHUS. Thank you.

Chairman Bair.

STATEMENT OF HON. SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you, Mr. Chairman. I would also like to thank you, Ranking Member Sanders, and the members of the subcommittee for the opportunity to testify on behalf of the Federal Deposit Insurance Corporation concerning the Basel II international capital accord and Federal banking 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. At the outset, I would like to emphasize that we all support moving ahead to the next step in the Basel II deliberative process.

The FDIC board of directors recently voted to publish the Basel II notice of proposed rulemaking for public comment. U.S. bank and thrift regulators also are developing a more risk-sensitive capital framework for non-Basel II banks, known as Basel IA, which we hope to publish for comment in the near future.

While it is important to move ahead with the process, there's also agreement that we must not do so in a way that will result in significant reductions in capital or in the creation of competitive inequities among different types of insured depository institutions.

The agencies' most recent quantitative impact study suggested that the Advanced Approaches would result in a substantial reduction in risk-based capital requirements. The results also showed wide variations in capital requirements for similar risks.

The agencies found these results unacceptable, and as a result, included a number of important and essential safeguards in the NPR to address these issues.

I look forward to receiving comments on the NPR and I will approach those comments with an open mind. I particularly look forward to comments on the question of whether the regulators should allow alternatives to the Advanced Approaches.

We have had a number of requests to allow any U.S. bank to use the Standardized Approach to capital regulation that is part of the Basel II accord. The United States is the only country proposing to make the Advanced Approaches mandatory for any group of banks.

The Standardized Approach includes a greater array of risk rates than the current rules. It is simpler and less costly to implement than the Advanced Approaches. In addition, because there is a floor

for each risk exposure, it does not provide the same potential for dramatic reductions in capital requirements.

On the other hand, there is the argument that only the Advanced Approaches would provide an adequate incentive for the strengthening of risk management systems at our largest banks. Whether our largest banks should be required to use the Advanced Approaches is a fundamental issue, and again, I look forward to public comment on this question.

Before concluding my remarks on Basel II, I would like to say a few words about the leverage ratio. The FDIC has consistently supported the idea that the leverage ratio, a simple capital-to-assets measure, is a critically important component of our dual capital regime. I am very pleased that all the bank regulators have expressed their support for preserving the leverage ratio.

I understand that banks in most other Basel Committee countries are not constrained by a leverage ratio, and that effective capital standards around the world vary widely as a result. For this reason, I believe that the United States should ask the Basel Committee to initiate consideration of an international leverage ratio.

The leverage ratio has provided U.S. supervisors with comfort that banks will maintain a stable base of capital in good times and in bad times. Similarly, the establishment of an international leverage ratio would go far in strengthening the liquidity and stability of the international banking system and help limit the consequences of reduced risk-based capital levels with Basel II implementation.

The committee also asked us to discuss the proposed guidance on commercial real estate exposures. The need for this guidance stems from the substantial growth in commercial real estate lending at community banks 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.

Loan 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 in this growth.

The goals of the proposed guidance were to increase awareness of commercial real estate exposures, 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 concentration risk.

The FDIC and the other banking agencies have seriously considered commenters' views on this proposed guidance. We appreciate the importance of CRE lending, particularly for community banks, and do not intend to limit CRE lending activity that is prudently underwritten and appropriately managed.

In particular, we agree with the need to emphasize that the stated thresholds are not limits, but rather are designed to trigger heightened scrutiny to assure adherence to sound credit principles and best practices. Once these perspectives are reflected in the final guidance, it should provide a useful tool for both examiners and banks.

This concludes my statement. The FDIC appreciates the opportunity to testify regarding Basel II and the CRE guidance. I look forward to any comments or questions the subcommittee may have.

Thank you.

[The prepared statement of Chairman Bair can be found on page 78 of the appendix.]

Chairman BACHUS. Thank you, Chairman Bair.

Now, Comptroller Dugan.

STATEMENT OF HON. JOHN C. DUGAN, COMPTROLLER OF THE CURRENCY

Mr. DUGAN. Chairman Bachus and members of the subcommittee, I appreciate the opportunity to discuss two important initiatives of the U.S. banking agencies—our proposals to enhance our regulatory capital program under Basel II and our proposed commercial real estate guidance.

The U.S. implementation of Basel II is, at its core, an effort to move away from the simplistic Basel I capital regime for our largest internationally active banks. The inadequacies of the current framework are pronounced with respect to these banks, which is a matter of great concern to the OCC because we are the primary Federal supervisor for the five largest; these institutions, some of which hold more than $1 trillion in assets, have complex balance sheets, take complex risks, and have complex risk management needs that are fundamentally different from those faced by community and mid-size banks.

Because of these attributes, Basel II is necessarily complex, but it would be mandatory for only a dozen large U.S. institutions. The new regime is intended not only to align capital requirements more closely to the complex risks inherent in these largest institutions, but, just as important—and this is a complete departure from the existing capital framework—it would also require them to substantially improve their risk management systems and controls. This would be accomplished using a common framework and a common language across banks that would allow regulators to better quantify aggregate risk exposures, make more informed supervisory decisions, disclose more meaningful risk information to markets, and make peer comparisons in ways that we simply cannot do today.

Last week, as you've heard, the agencies took a critical step forward in this process by approving the NPR. In addition to establishing the basic Basel II framework in the United States, the NPR addresses two key issues about implementation.

The first concerns the reliability of the framework itself. As you know, last year's quantitative impact study of the potential impact of an earlier version of Basel II predicted substantial drops and dispersions in minimum required capital. These QIS–4 results would be unacceptable to all the agencies if they were the actual results produced by a final, fully supervised and implemented Basel II rule. But they were not. Some changes already made in the proposed rule and others that will be considered after the comment period, should mitigate the QIS–4 results. More importantly, we believe that a fully supervised implementation of a final Basel II rule, with examiners rigorously scrutinizing the inputs provided by

banks, is likely to prevent unacceptable capital reductions and dispersions.

We cannot be sure, however. That's why the proposed rule will have strict capital floors in place to prevent such unacceptable results during a 3-year transition period. This will give us time to finalize, implement, supervise, and observe "live" Basel II systems. If, during this period, we find that the final rule would produce unacceptable declines in the absence of these floors, then we will have to fix the rule before going forward, and all of the agencies have committed to do just that.

The second issue concerns optionality. The NPR asks whether Basel II banks should have the option of using a simpler approach. This is a legitimate competitive question, given that the largest banks in other Basel II countries have such an option, although, as a practical matter, all such foreign competitors appear to be adopting the advanced approaches. We are very interested in comments about the potential competitive effects of providing such an option to U.S. banks.

The OCC has been a frequent critic of many elements of the Basel II framework, and we've worked hard to make important changes to the proposal that we thought made sense. But at critical points in the process, the OCC has supported moving forward toward implementation. Our reason for doing so is simple. An appropriate Basel II regime will help both banks and supervisors address the increasingly complex risks faced by our largest institutions.

While we may not yet have all the details right, and we will surely make changes as a result of the public comment process, I fully support the objectives of the Basel II NPR for the supervision of our largest institutions. Likewise, for non-Basel II banks, I fully support our interagency effort to issue the so-called "Basel IA" proposal in the near future as a way to more closely align capital with risk without unduly increasing regulatory burden.

Let me turn now to the proposed interagency guidance on commercial real estate lending, which the agencies proposed for three reasons.

First, although circumstances are different today and underwriting standards are much improved, we know from the painful experience of just 20 years ago that commercial real estate lending has the real potential to fail banks.

Second, during the last 5 years, we have seen a dramatic surge in the concentrations in commercial real estate lending in community and mid-size banks, to levels beyond what they were in the 1980's.

And third, our examinations revealed that risk management practices in many of these banks have not kept pace with the surge in concentrations.

While we believe that commercial real estate concentrations can be safely managed, they must be effectively managed in order to be safe. Accordingly, the basic message of the proposed guidance is not "cut back on commercial real estate loans." Instead, it is this: "You can have concentrations in commercial real estate loans, but only if you have appropriate risk management and capital to address the increased risk." And when I say "appropriate risk man-

agement and capital," that does not refer to expertise or capital levels that are out of reach or impractical for community and mid-size banks. Indeed, at its core, the proposed new guidance amplifies guidance the agencies developed in the wake of the widespread bank failures of the 1980's.

In addition, the overwhelming majority of banks affected by the guidance already hold capital significantly above the regulatory minimums, so these institutions generally would not be affected by the capital adequacy part of the proposed guidance.

The proposed guidance would establish thresholds to help us determine where enhanced risk management and adequate capital are needed. I know some banks worry that the thresholds will turn quickly into caps. But I can tell you categorically that this is not what the guidance says and not how it would be implemented. The OCC is emphasizing this very point—that these are thresholds for better prudential practices, not caps—in discussions with our examiners in every region of the country.

In closing, let me emphasize that as we move forward with these proposals, the agencies will continue to foster an open process, consider all comments, heed good suggestions, and address legitimate concerns.

Thank you very much.

[The prepared statement of Comptroller Dugan can be found on page 117 of the appendix.]

Chairman BACHUS. Thank you.

Director Reich.

STATEMENT OF HON. JOHN M. REICH, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. REICH. Thank you, Chairman Bachus, Ranking Member Frank, and members of the subcommittee. I appreciate the opportunity to be here this morning. Borrowing a phrase often repeated in Washington, that everything has been said and not everybody has had an opportunity to say it, I'm going to make a few brief comments and be quiet.

Let me say that OTS is supportive of the Basel II advanced approach and we are supportive of considering the standardized approach. Also, I'm very supportive of the safeguards that we have included within Basel II.

I believe that the longer implementation process will provide us with ample information, ample time over the next few years between now and the end of 2011 to have the opportunity to make any changes that we feel may be necessary.

Regarding Basel IA, I'm very supportive of dating Basel I but I also expect to be supportive of permitting the very well-capitalized banks who have indicated a preference to continue operating under the present Basel I framework to be able to do that.

With regard to the proposed commercial real estate guidance proposal issued in January, we're supportive of the general purpose and intent to remind institutions that credit concentrations can pose risks and that these risks should be assessed and addressed, further, that risk management practices should be commensurate with the level of concentration of commercial real estate loans within the portfolio. The guidance has drawn substantial negative

reaction, particularly to the specific thresholds which are included in the guidance.

As a former community banker, I'm keenly sensitive to these issues and highly cognizant of the magnitude of the public comment received and the nature of that comment.

My expectation is that the guidance should be viewed as a set of guidelines by the industry and our examiners. The proposed guidance is not a rule.

As we continue to work on the guidance, I'm hopeful that it can be modified to address the comments that we have received and to clarify the Federal banking agencies risk management expectations for the industry and to make sure the guidance conveys this intent more clearly.

I look forward to working with my colleagues on this panel in finalizing the guidance.

Thank you very much, and I'll be happy to answer questions.

[The prepared statement of Director Reich can be found on page 244 of the appendix.]

Chairman BACHUS. Thank you.

Acting Director Colby.

STATEMENT OF ROBERT L.D. COLBY, ACTING DIRECTOR, DIVISION OF MARKET REGULATION, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. COLBY. Chairman Bachus, Ranking Member Sanders, and members of the subcommittee, I'm very pleased to have the opportunity this morning, on behalf of the Securities and Exchange Commission, to describe the Commission's program for monitoring capital at U.S. securities firms.

While the Commission has applied a conservative net capital rule for many years to broker-dealers, as the securities business has expanded and broker-dealers became part of international financial conglomerates, the Commission became increasingly concerned about the risks that a broker-dealer may fail, due to the insolvency of its holding company or affiliates.

Therefore, in 2004, the Commission amended its net capital rule to establish a voluntary alternative method of computing net capital for well-capitalized broker-dealers that have adopted strong risk management processes.

This alternative method permits a broker-dealer to use mathematical models to calculate net capital requirements for markets and derivatives-related credit risk.

As a condition to that method, the broker-dealer's ultimate holding company must consent to group-wide Commission supervision, thus becoming a consolidated supervised entity, or CSE.

Formally supervising the financial condition of the broker-dealer holding company and its affiliates on a consolidated basis allows the Commission to monitor better and act more quickly in response to any risks that affiliates and the ultimate holding company will pose to regulated entities within the group or to the broader financial system.

The Commission's program to supervise the CSE's also responded to concerns of the U.S. investment banks regarding the ap-

plication to their activities in Europe of the European Union's financial conglomerates directive.

The directive requires that firms active in Europe be supervised at the group level under a regulatory approach equivalent to those applied in the European Union or face significant restrictions on their activities.

The European Union has recognized the broad equivalence of the Commission's CSE oversight program.

Currently, five U.S. investment bank holding companies are supervised as CSE's. Under the Commission's program, the ultimate holding company must provide the Commission with information at the group level covering its global businesses whether or not these activities are conducted in functionally regulated entities.

Those affiliates that do not have a principal financial regulator as well as the holding company itself are subject to examination by the Commission.

The CSE rule requires monthly calculation at the holding company level of a capital adequacy measure that's designed to be consistent with the standards adopted by the Basel Committee on Banking Supervision.

In requiring a holding company calculation of capital in accordance with the Basel standard, the CSE rules do not specify that capital adequacy be calculated using the original framework, Basel I, or the revised framework, Basel II. Likewise, the rule does not prescribe the use of advanced approaches contained in Basel II.

Nevertheless, four of the five CSE firms have elected, with Commission support, to satisfy the CSE capital calculation requirement by applying Basel II in its advanced approach to credit risk exposure.

The fifth firm, who because of its fiscal year was confronted with a period of only 6 months between publication of Basel II and the effective deadline imposed under the E.U. financial conglomerates directive, opted to apply Basel I, but this firm is now in the process of preparing to implement Basel II.

When the CSE firms began in earnest to implement Basel II during the latter part of 2004, the only complete description of the standard was the mid-year text. Thus, this text served as the basis for implementation of Basel II by these firms.

This is not to say that implementation of Basel II by the CSE forms has been simple. The Commission staff has worked collaboratively with our banking colleagues to address issues that are central to the CSE firms, and we believe that the CSE firms have implemented Basel II in a manner that's conservative while also reflective of the fundamental nature of the securities firms and their business model.

Looking ahead, with the U.S. banking regulators' formal issuance of their notice of proposed rulemaking, Commission staff will review the document carefully to apply the proposed approaches to securities firms in the context of their history, risk profile, and business mix.

Where further modifications to the calculation methodologies used by the CSE firms are warranted, the Commission has authority to require their adoption. The CSE firms understood, when they elected to apply the Basel II standard in 2005, that the standard

was still very much a work in progress and they were likely to have to make various adjustments as the broader U.S. implementation process proceeded.

In summary, we're confident that the CSE firms are currently calculating capital adequacy measure consistent with Basel II in a manner appropriately sensitive to the risks assumed by the firms.

To the extent that further modifications of the calculations become necessary, and to achieve to the maximum extent possible consistency with national and international regulatory authorities, the Commission has the commitment and the authority under the CSE rules to ensure that appropriate changes are made.

Thank you.

[The prepared statement of Mr. Colby can be found on page 113 of the appendix.]

Chairman BACHUS. Commissioner Antonakes.

STATEMENT OF STEVEN L. ANTONAKES, MASSACHUSETTS COMMISSIONER OF BANKS, ON BEHALF OF THE CONFERENCE OF STATE BANK SUPERVISORS

Mr. ANTONAKES. Good morning, Chairman Bachus, and distinguished members of the subcommittee. My name is Steven Antonakes, and I serve as the commissioner of banks for the Commonwealth of Massachusetts. I also currently serve as the chairman of the State Liaison Committee to the FFIEC.

I'm pleased to testify today on behalf of the Conference of State Bank Supervisors. 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.

While Basel II and the commercial real estate, or CRE, guidance are clearly very important regulatory proposals, both have the potential to impact the domestic financial system and could do particular harm to community banks by altering the competitive landscape and leading to the shifting of risk among business lines.

The role that a small bank plays in a local economy cannot be overstated. I'm sure that each of you is well aware of the benefits that are added to your districts by healthy, well-capitalized banks of all sizes.

It is our responsibility as regulators and legislators to ensure that regulatory proposals are prudent and do not create a competitive imbalance.

CSBS is pleased with the inclusion of several of the safeguards discussed already today that have been incorporated into the Basel II NPR. While we're encouraged by the incorporation of these safeguards, we do have process concerns.

Despite our status as the primary supervisor for the vast majority of banks in the United States, State supervisors have not been included in the drafting process of Basel II. State regulators, through CSBS, should have a seat at the table when rules that affect our institutions to such a substantial degree are being considered.

Additionally, the Basel II NPR does not provide a defined rule for the States during the qualification process. There are 10 States, including my home State of Massachusetts, that charter potential

Basel II banks. For these banks, the State is their primary regulator and must have a role in the implementation of Basel II.

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 all Basel II institutions regardless of their chartering agent. Accordingly, information sharing with the Federal bank regulatory agencies will be essential for States to properly supervise our Basel II banks.

In reference to the proposed CRE guidance, we share many of the worries that motivated its drafting. However, as regulators, we must not be overly prescriptive in how risk is managed.

In our opinion, the benefits of the guidance do not outweigh the potential negative impact on competition and our communities. Moreover, the guidance could have unintended consequences upon the health of the community banking system and the availability of credit.

The implementation of either the Basel II NPR or the proposed CRE guidance could significantly impact our Nation's financial system. Sufficient capital must be maintained to ensure safety and soundness and economic stability, and competition in the industry must be preserved.

Our fear is that the impact of one or both of these proposals will result in damage to community banks and a dual banking system as a whole.

CSBS seeks to sustain the economic vigor of the local communities we serve. Certainly we share that goal with every member of the subcommittee.

The vast majority of U.S. banks are state-chartered and it is critical that State regulators are given a full role in the regulatory process as these and other proposals are discussed, debated, drafted, and adopted.

I commend you, Chairman Bachus, and the distinguished members of the subcommittee for addressing these matters, and on behalf of CSBS, I'd like to thank you for the opportunity to testify.

[The prepared statement of Mr. Antonakes can be found on page 68 of the appendix.]

Chairman BACHUS. Thank you.

I appreciate the first panel's testimony. I think it certainly helps us understand where we are. I'm going to ask two questions.

First of all, it's my understanding that large banks in Europe and Asia will be subject to the Basel II rules in more or less the same form that was agreed to internationally, but I've been told that the U.S. proposal is significantly different in the advanced capital approaches, different from the advanced approaches that have been implemented abroad, and that for similar asset portfolios, U.S. banks will likely have significantly higher minimum capital requirements.

First of all, is that correct? And if it is, would this not be a competitive advantage for foreign banks over our domestic banks? First of all, are there going to be greater capital requirements for our banks, and if that's the case, won't that disadvantage us from the competitive standpoint?

Governor?

Ms. BIES. Mr. Chairman, let me respond in two ways. We have had more time than some of the other national regulators to look at the analysis of the QIS–4, and the QIS–5, which was done in other countries but not the United States, because they're on a faster timetable.

We've included in our NPR some strengthening from the 2004 mid-year agreement, where we did see some weaknesses. For example, we have a placeholder in the NPR that acknowledges that models that we saw were not strong enough for downturn loss estimates, and so it's a methodology to use, because what we saw in QIS–4 and QIS–5 is, when banks didn't know how to measure their downturn loss, they just used zero.

Well, in our view, your downturn loss should be higher than your best loss of zero; and yet, when you look at the QIS–5 report that came out of the Basel Committee, they acknowledge that it's something that still has to be looked at by other countries, and we're anticipating that they will also make some adjustments as the banks are observed in the parallel run. So some of these, I think, are timing differences.

Chairman BACHUS. What if they don't? What if they don't make those adjustments? What I hear you saying is that you're using this international agreement to strengthen or to increase capital requirements domestically.

Ms. BIES. We're doing it in our national implementation, in our NPR. There are several areas where the Basel Committee knows we have further work to do on Basel II, and we've all agreed to continue to work on that together as we get more information.

Chairman BACHUS. But are you saying that you anticipate some of the other countries raising their capital requirements, but they haven't done that yet, but you're almost raising ours anticipating that they'll raise theirs?

Ms. BIES. What I'm saying is that what we've done so far is to implement specific changes that respond to risks in the existing 2004 mid-year agreement. Those weaknesses other countries acknowledge, but they have not yet done anything to move forward at their national level to implement any change.

Chairman BACHUS. Now, if they don't implement those changes, though, it leaves us at a competitive disadvantage, does it not?

Ms. BIES. Well, it could. But on the other hand, we've had differences all along in capital rules.

Chairman BACHUS. Yes.

Ms. BIES. Part of this deals with differences in accounting rules. We still don't have global accounting. Some of that will make a difference.

Chairman BACHUS. I'm not sure that an international accord is the proper place to unilaterally raise our capital requirements.

Ms. BIES. But as a U.S. regulator, my first priority is to make sure banks in the United States have strong capital.

Chairman BACHUS. I understand that. But to say it, to say you're doing it as a part of an international process, but, you know, that it needs to be done for Basel II wouldn't be correct, I mean, not necessarily. You're saying it—

Ms. BIES. We're doing it in the U.S. NPR, but I'm saying the issues that we're concerned with are shared globally around the

table for Basel, and we know that there will be work in train to address some of the issues.

Chairman BACHUS. But you understand what I'm saying?

Ms. BIES. Yes. But we need to move forward and deal with it in the United States.

Chairman BACHUS. But would you acknowledge that, you know, if you came to Congress and said, "We need to do these things because of Basel II, but we're going beyond what we're required to do in an international agreement," then it wouldn't be a requirement.

It would be as if you're telling me the Fed may be going beyond what it's required to do, or that we're going beyond what we're required to do in raising our capital requirements.

In other words, starting 2 and 3 years ago, I think our institutions were told, as a part of an international agreement, you know, we're going to implement certain requirements, but in fact, if our foreign competition, those requirements are not—if their countries, their regulators don't require them to do that, then I see that as a disadvantage, and I know Mr. Feeney and Mr. Hensarling and Mr. Price, several of us on both sides of the aisle have actually expressed concerns that these international agreements don't disadvantage our banks in the global marketplace.

Ms. BIES. I think we are very proud that in the United States we consider our capital standards to be the strongest in the world, and we're not going to weaken them.

Chairman BACHUS. Sure.

Ms. BIES. And this has not disadvantaged our banks. They continue to have the strongest capital and the highest profitability, if you look at financial institutions elsewhere, and I think it's because we've been pushing a balance between capital and enhanced risk management, and you need to look at all of these together, and I think the results are that our banks are very effectively managing through this.

We need to always aspire to make sure that our banks are seen as a source of strength.

Chairman BACHUS. I think you could say there's a sense of pride in that our capital requirements are strict, but I think that anytime a capital requirement is higher than justified, then it raises costs, and, you know, there are unnecessary costs then.

And I don't want to debate the philosophy. What I'm simply saying is, if we're doing this as a part of Basel II, because it's necessary as a part of the international agreement, but, you know, what we've sort of been told is that it's going to happen overseas, in other words our competition is going to—these requirements are going to be put on those so we won't be disadvantaged.

Now, I appreciate your candidness, I mean, in saying that you're anticipating that they're going to catch up with us, but if they don't, I'm just saying there could be some problems.

Mr. Dugan.

Mr. DUGAN. Mr. Chairman, I do want to say that I think most of the provisions of our version of the advanced approaches and what the Europeans have adopted are pretty similar. There are some safeguards that I mentioned in my testimony that we put in, particularly on a temporary basis, because we were concerned

when we did our study that the drops in capital were a lot bigger than we thought they would be. We put in some capital floors during a 3-year transition period, but if we get comfortable with the rule and it doesn't produce those kinds of declines once it is fully implemented, then those floors should come off. And of course, there is always the leverage ratio that applies in the United States but does not apply outside the United States, and that is a difference.

Chairman BACHUS. Okay.

Ms. BAIR. I would just, I would agree with everything that my colleagues have said, and re-emphasize that's one of the reasons why I think it would be good to engage the international community on an international leverage ratio to the extent we may confront competitive inequities.

I agree with Governor Bies, I'm not sure low capital is a competitive advantage for the United States. I think our high capital levels have been a strength of the U.S. banking system and have certainly been an important buffer for the Federal Deposit Insurance Corporation in protecting the funds against bank failures.

So I think the premise of the question, I think we need to think hard about whether low capital really is a competitive advantage, and also, to the extent we do have differences, that we should engage the international community in an international leverage ratio.

Chairman BACHUS. Thank you.

Ms. Kelly.

Ms. KELLY. Thank you, Mr. Chairman.

I'll address this to you, Comptroller Dugan.

You note in your testimony that guidances are often interpreted as caps by bankers. In the recent experience of this committee, guidance on the MSB's was also, de facto, turned into caps by examiners in the field, despite regulator assertions to Congress of the contrary.

I'd like to ask each of the regulatory agencies here if their small bank examiners have specialized training in different types of commercial real estate and the commercial real estate cycle.

So I'm asking this basically of you first, Mr. Dugan, and then I'd like to hear from the other regulatory agencies.

Mr. DUGAN. Mrs. Kelly, we take great pride in the training that we provide our examiners at the OCC. At the heart of what examiners learn from their first day on the job is safety and soundness supervision, and although there are many things that we have to supervise institutions for, credit is at the heart of much of what examiners learn as a core skill.

I absolutely think we have the expertise. It's something that all of the agencies have focused on because of the problems that occurred in the 1980's when we sat in this hearing room, in front of the subcommittee members, because of all the bank failures that were caused by concentrations of commercial real estate lending.

And I want to emphasize that. What we're talking about here is not that commercial real estate lending is bad, because it's not. But a prime principle of bank supervision is not putting all your eggs in one basket, and we have seen such a dramatic rise in concentra-

tions that we want to make sure institutions are appropriately managing those risks.

Ms. KELLY. Who's going to pick that up next?

Mr. REICH. I'll be happy to. I have a little bit different perspective.

I share Comptroller Dugan's comments about the training that our examiners receive in all of our agencies, and I share his views about their abilities to examine various types of commercial real estate loans. But my perspective as a former community banker, and I've been away from it for quite a few years now, but as a former community banker, I am keenly aware of the power of the bully pulpit which we occupy as the heads of our regulatory agencies, and I do have concerns that the degree of proscriptiveness that is in the current proposal for commercial real estate lending may have some consequences that we do not necessarily want to see.

And so I am hopeful that, as we continue to work on the guidance before it goes out, that we modify it to be clear about our intent and not to suffer unintended consequences.

Ms. KELLY. That's certainly refreshing.

It's a very big concern that the examiners get out in the field and they don't have clarity of what the intent truly is, and then they will take a guidance, turn it into caps, as we've seen that before.

I'm also concerned that asset class concentration levels issued in the preliminary guidance are discriminatory against commercial real estate as opposed to other types of bank assets.

In particular, the ILC's often have 100 percent of their businesses in unsecured credit card debt and vehicle payments, but the FDIC defends their safety and soundness, so how secured or partially secured debt, how can secured or partially secured debt for real estate combined with holding company supervision be any more risky than holding a portfolio that's made up entirely of credit cards that are marketed to teenagers? I want to know why you're not mandating portfolio diversity for these institutions.

Ms. BAIR. Congresswoman, I don't think by issuing the CRE guidance that we were suggesting that other types of risk exposures don't also need to be appropriately managed.

I think the overall—I would be happy to—I'm uncomfortable to try to get into institution-specific situations, but I think overall, the safety and soundness record of the ILC industry today has been a good one, and yes, diversification is a fundamental principle of lending, and to the extent there are concentrations in those types of depository institutions as well as others that perform service in niche markets, they need to have more stringent risk management systems and procedures in place.

But again, I don't think just because guidance was issued on CRE, that does not mean to suggest that other areas don't need to also be appropriately managed.

And as you know, we have a moratorium in place right now, and we will offer comment on some of the broader issues regarding the adequacy of holding company oversight and other unique issues presented by the ILC charter, and we have not completed that review, but should be trying to move forward with some of these issues early next year.

Ms. KELLY. I would hope that you would look at some of these institutions where they're marketing heavily to young people, and evaluate the quality of that risk vis-a-vis the quality of a local bank holding a risk-based mortgage on commercial property.

Thank you for your answer.

Yes, Ms. Bies.

Ms. BIES. Let me just add a couple of things.

One, to make you aware that we are working inter-agency on the training program for our examiners on the new guidance to make sure that we are sending the right message and that we will be consistent not only within our agencies but across our agencies on how the new guidance will be implemented, and that will be in train very quickly, too, to address your concern on the knowledgeability of examiners.

The other point I want to make about commercial real estate is, there are certain asset types where an individual bank can do a wonderful job in underwriting their credits, but they get contagion from poor underwriting by others, and it's really true in commercial real estate.

A bank can do a great job of underwriting, but if projects in their market are getting funded and create excess capacity so there are a lot of vacancies or they're poorly underwritten for cash flow, so the maintenance and the property values go down, it can negatively affect the bank because those other projects could, through rent concessions and other things, attract tenants to competitive projects.

And so what we're really emphasizing here is that the bank has to go beyond individual loan underwriting and look externally and make sure they're always aware of what's going on in the market, because unlike other types of credit, bad lending can really affect their good credits.

Ms. KELLY. Thank you, very much.

Ms. Bair?

Ms. BAIR. I just wanted to add one more thing.

Our examiners also go through a very rigorous training program through our corporate university, so I just want to get the flag up for our examiners as well.

I'm also advised that 2½ years ago we issued internal guidance to our examiners on commercial real estate exposures to remind them about what best practice is in terms of risk management and to differentiate that obviously within that broad category there are some types of assets that are more risky than others.

So yes, I have very—I've actually been told by several community bankers that they've had positive experiences actually when our examiners have come in and reviewed their CRE portfolios.

Ms. KELLY. Thank you.

Mr. HENSARLING. [presiding] The time of the gentlelady has expired. The Chair would now recognize the ranking member, Mr. Frank of Massachusetts.

Mr. FRANK. Thank you. I apologize. We have a bill on the Floor that I had to speak on.

I want to focus in on again on the CRE. And the regulators did respond, the four banking regulators, before Chairman Bair was there, her predecessor, her acting predecessor did it, but all four of

the agencies signed it, and it's a response to questions that were raised. And here's what troubles me.

I got on this committee because of my interest in urban issues. I've broadened it some. Being ranking member means a lot of perks, but it means losing one significant perk, which is the ability to ignore things you're not interested in. You now have responsibility for a whole lot of other stuff. So I accept that. But housing is still very important to me.

Multi-family housing is a great, serious social need, and I worry, and I really regret the fact that you appear to have swept multifamily lending into this guidance without, it seems to me, a basis.

What troubles me is it may be cultural—I don't know if you have the letter you sent me, but on page 5 of the letter, in chart 5, it has net chargeoff rate by loan type. I ask that this be put in the record, Mr. Chairman.

Mr. HENSARLING. Without objection.

Mr. FRANK. In 1991 and 1992, multi-family—let me just ask my colleagues, please, could I—I'm sorry, could you not be in the way here?

In multi-family, in 1991 and 1992, chargeoffs for multi-family were significantly higher than the average of all loans, 2.10 to 1.61 in 1991; 1.63 to 1.28 in 1992. Then you began to get parity between the multi-family and the average up until about 1996.

Beginning in 1997 and through 2005, multi-family chargeoffs have been 25 percent or less than the average to the point where, in the past couple of years, in 2005, multi-family chargeoff, .04 percent. Similarly, in 2004. In 2004, that's a 15 to 1 ratio. It's 1/15th as much for multi-family as all loans. It's 1/16th in 2005. In 2003, .03 to .91.

There does not appear to be any reason that multi-family homes have been swept in here. Again, it's cultural. Yes, they were a problem, and you say this. Well, we had these problems in the 1980's, late 1980's, and early 1990's. I went through it. It was a terrible problem. But that's no reason to deal as if things hadn't changed.

And so given this—and by the way, none of the categories here, all loans, .54 percent chargeoff in 2005. For multi-family, .04. For non-farm, non-residential, .05. For construction and land development, .03.

In fact, by your chart, for the last 8 or 9 years, the loans about which you are worried have been significantly lower in chargeoffs than the other loans, so that when you single those out, that's why people get nervous.

Could you address that? I mean, why did you put multi-family in here when it has performed so well for the last 10 years?

Let me ask any of the regulators.

Mr. REICH. Well, Mr. Frank, I would plead guilty to signing onto a letter that I didn't necessarily agree with everything in it. I agreed with—

Mr. FRANK. The letter to me?

Mr. REICH. I believe that's the letter that you're referring to. That letter.

Mr. FRANK. Mr. Supervisor, that is very odd behavior.

Mr. REICH. Well, let me elaborate.

I share your concern about multi-family lending. We at OTS have been working with our regulatory colleagues to try to make some progress in this area.

I totally agree that lumping multi-family loans with shopping malls, strip shopping centers, office buildings, and warehouses, with the experience that you just cited that has taken place over the last 10 years, is inappropriate.

Mr. FRANK. Thank you.

Mr. REICH. And I would like to work with my colleagues in the days and weeks to come to—

Mr. FRANK. Well, I appreciate that.

We are also talking about activities which are not all of equal social worth, and if people think that's an irrelevancy, let me cite the law called the Community Reinvestment Act.

And I do not think that items that will get a bank Community Reinvestment Act credit are to be treated identically with items that don't.

You know, to some extent, we're pushing them with one hand and pulling them with another, and telling them they got to do this for CRA credit, but then make—I wonder if any of the other regulators would tell me why they think multi-family should continue to be treated the same as everything else in here, although I have to say in fairness to construction and land development and non-farm, non-residential have also been low, though not as low as multi-family.

Let me ask Mr. Dugan.

Mr. DUGAN. Mr. Frank, if you go back and look at those losses in the 1980's, they were in a family of risk exposures that did share some correlation. They track each other over a long period of time, and they depend on rents, whether it's residential or non-residential.

We've gotten a lot of comments about not just multi-family, but residential real estate construction over time having been less risky than office rentals. But both are part of a family of exposures where we have seen the risks move somewhat in the same way.

But the main thing I want to come back to is, and I know you had concerns that you expressed in your opening statement, we're not telling people not to do this. We really aren't. We're saying—

Mr. FRANK. Do you really think that this has no effect of that sort of a discouraging kind?

Mr. DUGAN. I didn't say it would have no effect because I think it should have an effect. That's why we're putting it out. We want—

Mr. FRANK. A discouraging effect? Do you think, everything else being equal, that they may say, "Well, you know what? Maybe we'll do less here and more there"?

Mr. DUGAN. I think that when institutions have concentrations, and we say they're going to have to pay more attention to it because concentrations have failed institutions in the past, and they have to do more, yes, that can be—

Mr. FRANK. Okay. But then again—and you know, you say, well, they're all in the same bucket. You made the bucket. I mean, you know, God didn't decide that all these—that construction and land development had to be the same as multi-family.

The fact is that the numbers do differentiate. Other buckets, other types are, it seems to me, treated in a more risky way. But there's a real difference. C&I loans do appear to have been more risky in some ways.

But, you know, it's been 13 years. Not in 13 years have multifamily loans been subject to a higher chargeoff rate than others. And so when you tell a bank, "Be careful about these and not about the others," or "Be more careful about these than the others," you have the negative effect, and I would hope you would reexamine that. It doesn't have to all be in the same bucket. You can have more buckets.

You know, if we need to appropriate more buckets for you, we'll do it. You don't have to put them all in one thing. And when things are not—you know, maybe you should watch Sesame Street, Mr. Comptroller. One of these things is not like the other, you take that into account.

Thank you, Mr. Chairman.

Mr. HENSARLING. The Chair now recognizes himself. And as the father of a 4-year-old, and a 2-year-old, I actually do watch Sesame Street. I'm very familiar with that routine.

I would like to follow up somewhat on the line of questioning of the ranking member, because it's a consistent theme that I hear from bankers in the Fifth District of Texas, and that is that they feel that the CRE guidance is essentially a single bucket that does not account for the diversification of various CRE product types, geographical diversification, and variance in loan to value ratio.

So I would like a little bit more specificity in addressing the concerns of the bankers that I deal with in how do you plan to treat these variances and will we see many buckets as opposed to one bucket.

Whoever would like to hop in here first.

Ms. Bies?

Ms. BIES. Congressman, let me put in perspective what we intended with these 100 and 300 percent benchmarks. We didn't intend these to be ceilings.

When we scope out exams we try to, from afar, look at a bank and look at what's changing in its risk profile. We use our call reports to do that; and unfortunately, our call reports today classify loans by collateral, not business purpose.

So what we are trying to say to our examiners is, because of where we are in the credit cycle, we want to make sure that we're getting more information on the kind of commercial real estate that's there. They can only do that by engaging directly with the bank.

So for example, we know that some of the loans that are classified as commercial real estate are really loans that were made to small businesses and middle-size companies, and in an abundance of caution, the banks takes a mortgage lien on the property in case the business cash flow doesn't work.

That is not the commercial real estate we want to describe, but today's call report lumps it in as commercial real estate. We are looking to change the call report classification so we get better surveillance. One of the challenges we've got is trying not to create too many buckets in the call report and make it difficult to handle.

But what we want the examiners really to do is to step back and meet with the bankers and say, “What is the mix of your lending, what kind of projects are you in, what varieties do you have, how do you monitor that?”

They have to have that conversation by engaging with the bank. That was the intention, to say, “You need to begin to have these conversations when the concentration on the call report gets above that level.” It wasn’t intended as a ceiling. It was intended as the beginning of more conversation.

Mr. HENSARLING. Anyone else want to pick up the bucket metaphor?

Mr. DUGAN. The thing I would amplify is that part of what we’re asking is that bankers be able to show that they have those different levels of risk. That’s exactly the kind of reporting and risk management that we’d like to see, a demonstration that they know where their risks are. When we examined some of the institutions, they couldn’t tell us much about their risks, not even in some cases what was owner-occupied and what wasn’t, which is a pretty basic thing. And so the guts of this is, if you want to be in commerical real estate in a bigger way, you have to have more sophisticated ways to look at it to make these kinds of distinctions, and that’s the kind of thing that will give comfort to examiners.

Mr. HENSARLING. As a firm believer in anecdotal evidence, would anybody else on the panel care to elaborate what they’re hearing from their field examiners, and what might be lacking in certain risk management or reporting problems that you’re hearing and seeing regarding the CRE concentrations?

Mr. REICH. Congressman, I would simply like to state that I think that putting out a reminder to the industry of the risks of concentration is a good thing. I’m totally supportive of our doing that.

But I do believe that being as proscriptive as we are, I hate to be the skunk at this garden party, putting out the guidance as proscriptive as it presently stands does run the risk of unintended consequences.

As a former community bank CEO, I well remember how I used to sort of hang on the words of the Comptroller of the Currency when I operated with a national bank charter.

The power of the bully pulpit is very strong, and when there are more than 3,000 bank examiners around the country trying to implement the guidance and supervise the institutions according to the guidance that we issue, I do have a concern that they will view these limits as caps and that consequences will be not what we as regulators intend for them to be.

I think that expressing the guidance without the numbers will be—is a good thing for us to do, and that in our speeches and outreach meetings with bankers we can express our concerns and those will be heard.

In fact, I’m under the impression that there are already some institutions that have assumed the guidance is the law of the land and they’re already changing their policies accordingly.

I’m also concerned about anecdotal evidence that I’m hearing that there are one or more financial analysts who are making buy and sell recommendations of financial institutions based upon

whether or not they have reached these thresholds that are in the proposed guidance.

Mr. HENSARLING. Thank you, Mr. Reich, and also thank you for your work on regulatory relief in your previous capacity.

The Chair's time has expired. At this time, the Chair will recognize the gentlelady from New York, Ms. Maloney.

Mrs. MALONEY. Thank you, and I thank the panelists. There was a bill I had to go to the Floor for. I apologize.

I'd like to ask Susan Bies and Mr. Colby and anyone else who would like to comment, the QIS–4 led the regulators to add their additional safeguards to the U.S. version of the accord. And do you think the QIS–4 is an accurate measure of risk?

Ms. BIES. Let me put QIS–4 in perspective. As the plan of work was put together several years ago for moving to Basel II, what we tried to do through the Basel Committee was encourage countries to take a measure periodically through the process to help us identify where banks are in risk management, what issues are there around the proposals, so that we could change them as we go.

QIS–4, and I would say the most recent one that was done globally that we didn't do, QIS–5, that was released in May, continue to find areas where we need to strengthen the framework.

Keep in mind that that's the goal, to help us do diagnostics on what needs attention, and it also allows the banks a way, in a consistent framework with other banks, to get feedback from regulators so that they may know where they're lagging behind in the development of the risk models.

Now, as the Comptroller said earlier, and my other colleagues mentioned, the way QIS–4 was actually done, none of us would have accepted QIS–4 as a standard we could use for banks. The models were too early. We didn't have our completed guidance out. There wasn't a track record to build the databases. There were a lot of issues.

So QIS–4, per se, if that was going to be reality, I don't think any of us would be wanting to use this as the framework, but it was meant to test where we are and look at how quickly we could move and what we needed to do.

So from that perspective, it generally reinforced that the kinds of things we're trying to do were moving in the right direction, and the quality of the work in QIS–5, for example, is better than what we saw in 4, and so we're seeing progress being made as we move forward.

Mrs. MALONEY. Would anyone else like to comment?

No? Okay.

I am concerned that if the present proposals are adopted, we will have one risk management standard for large banks and then a different one for small banks, and yet a different one for the securities market; and shouldn't we be concerned that this will create the same problems that Federal Reserve Governor Meyer was concerned about in Basel I back in 1991 when he said, and I quote—

I'm sorry, we're being called for a vote. We're not supposed to be called for a vote, so I don't know why they're calling us.

But anyway, to quote Governor Meyer on Basel I, he said: "Banks are engaging in capital arbitrage to move their higher-quality, lower-risk assets to the security markets or similar arbitrage

issues with the result being through the total capital charges are not proportional to the total risk.” And capital arbitrage was the reason given for many for moving away from Basel I, but aren’t we heading in a similar direction in creating a similar problem with Basel II?

And I’d like to ask Mr. Robert Colby and the Honorable Susan Bies.

Mr. Colby?

Mr. COLBY. Well, the implementation of the CSE rules was done at a time when the securities firms were working off an early Basel II text, and the story is not over.

Once the banking agencies move forward on their notice of proposed rulemaking, we plan to work with them to try to bring the two in as close alignment as we can.

Mrs. MALONEY. Honorable Susan Bies?

Ms. BIES. Thank you. First, let me address the small banks.

As we’ve been doing this exercise, we’ve done, as you know, at the Federal Reserve a series of white papers. Other folks have been doing research trying to look at competitive issues.

We’re still working inter-agency on our Basel I proposal, but I think you’ll see when that comes out in a few weeks that we are addressing those portfolios where the competitive impact is likely to be the greatest, and in putting it out, we’re going to be asking the bankers, are we focusing on the portfolios that we should have?

So we are very conscious of it, and have been spending time trying to craft that, while also listening to the smaller bankers who want to make sure that the framework to measure risk is not so burdensome that it adds to regulatory burden for them.

Mrs. MALONEY. I’m really very sympathetic to competitive equality, but what I’m concerned about is we’re in a global competitive market, and I’m concerned that American financial institutions, large or small institutions, not be put at a competitive disadvantage to foreign banks and financial institutions because of the capital standards, and at the same time, I’m very concerned about safety and soundness, and striking that balance to it.

But I keep hearing concerns from institutions that they feel the capital requirements are going to be heavier and more onerous on American institutions.

Ms. BIES. To keep the tie to American institutions, one of the things that we are moving toward is again, if you look at the more sophisticated products of the larger organizations and the historically different approach that securities regulators and bank regulators have had to capital, one of the things in that new market risk proposal that also came out with the Basel II NPR as a separate issue, we have been working very closely with securities regulators to try to make sure that a similar kind of position, similar kind of, say, subordinated debt tranche, whether it’s held in a commercial bank or a securities firm, would have similar treatment.

What was being proposed is something that globally we worked on, and the United States here, I think we’re getting closer as a result of this effort to similar treatment not just globally, but more importantly, between commercial banks and securities firms for those firms who do the risk-based kinds of capital.

So we are concerned about competitive issues, but we try to address them in the framework of safety and soundness and keep it strong.

Just as the U.S. bank regulators have very strong capital requirements and our banks have thrived in that environment, our securities firms also have a very strict capital requirement and they've thrived.

Mrs. MALONEY. Do you feel that our banks and securities firms are put at any competitive disadvantage in the Basel II because of the capital requirements?

Chairman BACHUS. If you could wrap this up fairly quickly.

Ms. BIES. There are some places where we've felt, as U.S. regulators, that we wanted something stronger, but those issues have also been discussed around the Basel table, and I really think many of these issues will be addressed long-term on a more global basis by other national regulators, too.

So there could be a timing difference, but in terms of the Basel II risk framework, I think we are getting closer.

Going to international accounting standards that are more harmonized is going to go a long way, also, to make the impact of capital rules more similar across countries. A big part of the world has never had capital on an off-balance sheet. They are finally getting it. We've had that for years. So I would say they've moving up to our standards.

That was a big missing piece in the global capital standard that we're picking up and that, too, is moving us closer together.

Mrs. MALONEY. Mr. Chairman, if I could get one brief comment from the New York banking supervisor and superintendent, Diana Taylor.

She indicated that she had not been called in on any conversations on this debate, and would appreciate it if the committee would listen to superintendents of banks across the country, that they have a point of view that they feel needs to be heard, also.

Chairman BACHUS. Thank you, Congresswoman.

Let me just wrap up with one question, which is what you've heard most of these questions are about.

I mean, we all agree that real estate lending ought to be done prudently. We further agree that, as a regulator, one of their primary duties is to see that it's done in a safe and sound manner and to examine portfolios, loan ratios, and all of these factors.

That having been said, you heard the concern expressed by Mr. Frank, Mr. Hensarling, and even, I think, Director Reich, that the guidance doesn't take into account the diversification, and that even though it's your intent that these are guidances to the examiners, that it may create as a practical matter arbitrary ceilings that don't relate to actual risk, and that by setting number thresholds, the concern is the examiners in the field may assume that these ceilings are absolute.

We've been assured, I mean, even today, that that's not going to happen, and earlier in correspondence, but there's certainly a lot of anecdotal evidence to show that the concern is justified.

You were mentioning a Wall Street analyst, Director Reich, and a lot of our banks are saying they're afraid that the examiner is going to treat it this way.

So my question is this. What plans do you have to address this concern and to ensure that the examiners are open to getting into the actual condition and diversification of a bank's CRE portfolio rather than simply assuming there's a problem?

Or maybe another way, just to say that in a simpler way, is how do you plan to address these concerns in order to ensure that the guidance will be implemented appropriately by these examiners?

Mr. DUGAN. Mr. Chairman, we have already heard those concerns loud and clear from the industry as bankers have come through and talked to us, and I think it's a legitimate apprehension that we have to always be vigilant about. But we have embarked on a campaign with our examiners, in every region of the country, with every examiner who examines community banks, to deliver the messages that you've just described, and we will follow up on that.

We encourage bankers to come to us with specific examples of where that's not occurring, and we will address the issue. I think we have to be sensitive, we have to keep repeating it, we have to monitor to make sure that it's clear, and that's exactly how we will approach it.

Chairman BACHUS. Thank you. I might want you all, maybe in the weeks to come, to write a letter to us, telling us in a little detail what you have done, or plan to do, in that regard.

I'll close by saying that we've talked about commercial loan, lending money for commercial projects, and we haven't mentioned residential as much, but I did read the new Chairman of the Federal Reserve's book on the causes for the Great Depression, and I'm not going to try to paraphrase him, because I'd be incorrect. He did say there were a lot of failures to do some things that you all are doing, but he also, one of the themes of that was the failure to lend money.

So sometimes a recession, depression, or bank failure can be because of imprudent lending. On the other hand, you can have a recession or depression based on too tight money, or the banks not lending money.

So I would hate to think that actually we end up with a downturn in the economy because of guidance which restricts commercial lending and therefore depresses the economy, and then, as a result of that, depresses commercial property values. So you might want to pull out his book and read it. Thank you very much.

We're going to recess for an hour and 15 minutes, because we have 45 minutes worth of votes on the Floor in actual minutes, so I don't think we can be back here before 2 o'clock, so we're just going to recess until 2 o'clock.

The first panel is discharged, and I very much thank you for your attendance and testimony.

[Recess]

Chairman BACHUS. Good afternoon.

First of all, I appreciate your patience in waiting.

I have read some of the testimony of the second panel, and I think it will be very valuable to us as we proceed.

At this time, I'm going to formally introduce the second panel, starting from my left. Mr. Harris Simmons, chairman, president,

and CEO, Zions Bancorporation, on behalf of the American Bankers Association. Mr. Simmons, where is that located?

Mr. SIMMONS. Salt Lake City.

Chairman BACHUS. Salt Lake City. Okay. We welcome you to the hearing.

Mr. Weller Meyer, chairman, president, and CEO of Acacia Federal Savings Bank on behalf of America's Community Bankers. 1And that's located in?

Mr. MEYER. Falls Church, Virginia.

Chairman BACHUS. Falls Church, Virginia.

Mr. James M. Garnett, head of risk architecture, Citigroup, on behalf of the Financial Services Roundtable. We know where you're located.

Mr. James McKillop, president and CEO of Independent Bankers' Bank of Florida, on behalf of Independent Community Bankers of America. And where in Florida are you?

Mr. MCKILLOP. Orlando.

Chairman BACHUS. Orlando. Okay.

And then Mr. Marc Lackritz, president, Securities Industry Association. Marc, it's good to have you back before the committee.

Mr. LACKRITZ. Thanks, Mr. Chairman.

Chairman BACHUS. Ms. Karen Shaw Petrou, co-founder and managing partner, Federal Financial Analytics. It's good to have you back before the committee. Ms. Petrou has testified before the committee on at least four or five occasions since I've been chairman.

Mr. Robert White, Jr., president of Real Capital Analytics. Where is that located, Mr. White?

Mr. WHITE. New York City.

Chairman BACHUS. New York City. We're glad to have you.

And finally, Dr. Glenn Mueller, professor, Burns School of Real Estate and Construction Management at Denver University. And we all know where Denver University is. Thank you.

So at this time, we'll proceed from my left to right, starting with Mr. Simmons, and I think opening statements are going to be limited to about 3 minutes, although, you know, if it's 3½ minutes, you won't be interrupted.

Thank you.

STATEMENT OF HARRIS H. SIMMONS, CHAIRMAN, PRESIDENT, AND CEO, ZIONS BANCORPORATION, ON BEHALF OF AMERICAN BANKERS ASSOCIATION, SALT LAKE CITY, UTAH

Mr. SIMMONS. Thank you very much, Chairman Bachus, for holding this hearing. The ABA appreciates the opportunity to express our views on these two very important issues.

Our Basel II message is simple. The current proposal will hurt U.S. banks that compete internationally. It requires compliance with the most complicated version of the international rules rather than allowing U.S. banks the same flexibility that banks have in other countries, and it adds layers of constraints that are completely at odds with the principle of tying capital to risk.

As a result, Basel II has evolved into a risk management exercise disguised as a capital rule. This can be fixed if the agencies adopt an approach very similar to the international Basel II accord.

To avoid creating a capital disparity in the U.S. domestic market, we believe it's critical that the regulators also revise the capital rules for all U.S. banks and implement those rules simultaneously. Without this, the contradictory capital rules will invariably lead to pricing advantages and shifts in market share.

It's crucial that all banks in a given market competing for similar assets have similar capital charges, especially when implementing a menu of capital rules. A menu of options could address effectively the international and domestic competitive issues.

We encourage the regulators to consider both the so-called Basel IA approach and the standardized approach under Basel II.

Regardless of the options provided, banks of all sizes and levels of sophistication should be able to select an approach that is both appropriate for them and that doesn't place them at a competitive disadvantage relative to one another.

Turning to the guidance on commercial real estate, I'd like to leave you with one point. The guidance as proposed could inappropriately choke off the flow of credit.

How many commercial real estate loans a bank makes is not the issue, it's how well that bank manages the risk, and a "one size fits all" approach as proposed simply doesn't address the risk management issue.

Moreover, there's a danger that an examiner will require more capital, regardless of how effectively a bank is managing the risk. This could tie up funds that otherwise would be supporting additional lending and it could also lead a bank into riskier activities to earn a return on that capital.

Community and regional banks are likely to be hit the hardest by this guidance, as commercial real estate lending is a particularly important activity for them.

It's not enough to soften the tone of this guidance. Examiners, hoping to avoid being second-guessed with problems that arise in their banks, may apply the guidance more harshly than the agency heads intended. To avoid this, the regulators should instead deal with problems on a bank-by-bank basis.

If, however, final guidance is issued, it should first be changed to clear up questions concerning the scope of the guidance and the role of capital when a bank has a commercial real estate concentration, and the bosses in Washington must ensure that the examiners in the field understand how the guidance is to be applied.

The ABA remains committed to working with the agencies on both the capital rules and CRE lending issues. I appreciate the opportunity to appear before you on behalf of the ABA and I look forward to answering any questions you may have.

Thank you.

[The prepared statement of Mr. Simmons can be found on page 253 of the appendix.]

Chairman BACHUS. Thank you, Mr. Simmons.

Mr. Meyer.

STATEMENT OF F. WELLER MEYER, CHAIRMAN, PRESIDENT, AND CEO, ACADIA FEDERAL SAVINGS BANK, FALLS CHURCH, VIRGINIA, AND CHAIRMAN, BOARD OF DIRECTORS, AMERICA'S COMMUNITY BANKERS, WASHINGTON, D.C., ON BEHALF OF AMERICA'S COMMUNITY BANKERS

Mr. MEYER. Chairman Bachus, my name is Weller Meyer, and I am chairman, president, and CEO of Acacia Federal Savings Bank in Falls Church, Virginia, but I appear today on behalf of America's Community Bankers, where I serve as chairman of the board of directors. Thank you for this opportunity to present our views.

Let me thank the committee for its substantial oversight of the Basel rulemaking process. Your interest has been instrumental in the progress made in ensuring the public interest is served. We also appreciate the thoughtful modifications made by the agencies to the initial proposals.

However, ACB remains concerned about unintended competitive, safety, or soundness consequences that might arise from the rulemaking. Basel II should not be implemented unless changes are made to Basel I to more closely align capital with risk for other depository institutions.

We are pleased that a proposal on Basel IA will soon be released by the agencies in response to this concern. We hope that the final capital standards will not add significant new regulatory burdens.

Flexibility is key to creating a successful new capital regime. This flexibility should include the option for Basel II banks to chose between the standardized approach and the advanced approach as contemplated in the international Basel II accord.

It also must include the establishment of a Basel IA standard that would permit the majority of banks to more accurately manage their risk and capital requirements, including additional risk buckets to more accurately measure credit risk. In short, the system must result in banks of all sizes having equivalent capital charges against equivalent risk.

Moreover, Basel I banks should have the option of continuing to comply with the current capital requirements, because that will be less burdensome for many community institutions.

Finally, we strongly support the regulators' intentions to leave a leverage requirement in place. A regulatory capital floor must be in place to mitigate the imprecision inherent in internal ratings-based systems.

Turning to another topic of today's hearing, we are concerned that the CRE guidance could create competitive burdens for community banks with substantial commercial real estate assets.

In particular, we see no need for potential capital surcharges for institutions that are well managed and well supervised. Any changes in capital requirements should be considered only as part of the Basel rulemaking and not through guidance.

We also have suggested two other substantial adjustments to the guidance. First, the threshold test for commercial real estate concentrations must be adjusted to focus only on those types of lending that are likely to reflect significant risk exposure. Second, the guidance should not establish a "one size fits all" standard for management of commercial real estate lending.

We thank the committee for its attention to these important issues, and I will be pleased to answer any questions.

[The prepared statement of Mr. Meyer can be found on page 185 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Garnett, I'm going to recognize Ms. Maloney just very briefly.

Mrs. MALONEY. Thank you so much. It is an honor to introduce Mr. Garnett, whom I have the honor of representing in New York. He is the head of risk architecture for Citigroup, where he is responsible for the oversight of group-wide market and operational risks. In addition, he is responsible for Citigroup risk performance reporting and measurements for all risks, including economic capital and credit risk rating, processes risk systems and implementation. He also receives all market risks for the Global Consumer Group, and we're delighted to have him here today.

I look forward to your testimony. Thank you.

Chairman BACHUS. Thank you. Mr. Garnett, that's why I didn't go into where you were from.

STATEMENT OF JAMES M. GARNETT, JR., HEAD OF RISK ARCHITECTURE FOR CITIGROUP ON BEHALF OF THE FINANCIAL SERVICES ROUNDTABLE

Mr. GARNETT. Thank you very much. Chairman Bachus, and members of the subcommittee, my name is Jim Garnett. Thank you for inviting me to testify today. I'm responsible for the implementation of Basel II for Citigroup, but I'm here today on behalf of the Financial Services Roundtable.

I would like to begin my testimony by emphasizing that the Roundtable strongly supports the implementation of Basel II in the United States. The Basel II accord is intended to better align regulatory capital to underlying economic risks. It is also intended to promote equality in the international regulatory capital standards.

Last month, the Roundtable wrote to the Federal banking agencies expressing concern over inconsistencies between these goals and the proposed U.S. version of the accord. In its current form, the Roundtable believes that the U.S. version of the accord: one, is not appropriately risk-sensitive; two, disadvantages American banks against foreign competitors; and three, creates significant compliance cost issues.

The answer to our concerns is twofold. First, harmonize the U.S. version of the accord with the internationally negotiated text. Second, offer all U.S. banks the same options for compliance that are available internationally.

Harmonization of the accord would prevent foreign banks from gaining a competitive advantage over U.S. banks and better align risk and capital. Offering U.S. banks compliance options such as the advanced approach, the standardized approach, or Basel IA is equally important.

Giving all American banks, large and small, a choice of methods for risk-based capital compliance has several benefits. Choice gives banks of all sizes access to simple and transparent methods. Choice assures a competitive marketplace, both domestically and internationally.

And finally, choice promotes safety and soundness by ensuring appropriate minimum regulatory capital requirements.

In summary, the Roundtable supports the development of modern risk-sensitive systems. The international accord is such a system.

The proposed U.S. version of the accord, however, is inconsistent with the international accord. This creates significant risk, competition, and compliance concerns.

We urge the harmonization of the U.S. version of the accord with the international version and we recommend that all banks be given a choice of compliance options. We hope Congress can endorse these objectives as the rulemaking progress moves forward.

Thank you.

[The prepared statement of Mr. Garnett can be found on page 138 of the appendix.]

Chairman BACHUS. Mr. McKillop.

STATEMENT OF JAMES H. McKILLOP, III, PRESIDENT AND CEO, INDEPENDENT BANKERS' BANK OF FLORIDA, LAKE MARY, FLORIDA, ON BEHALF OF INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA), WASHINGTON, D.C.

Mr. MCKILLOP. Thank you, sir. Mr. Chairman, Ranking Member Maloney, and members of the subcommittee, I am Jim McKillop, president and CEO of the Independent Bankers' Bank of Florida, but I appear today on behalf of the Independent Community Bankers of America.

ICBA appreciates this opportunity to testify on the bank regulatory agencies' proposed guidance on commercial real estate lending and on the agencies' proposal to implement Basel II rules. I want to compliment the subcommittee for taking up these difficult regulatory issues so late in the Congressional session. These proposals deeply affect community banks in their ability to serve their communities.

IBB, my bank, serves over 270 community banks in Florida, the southern portions of Georgia and Alabama. We have CRE loans in excess of 600 percent of capital. As a bankers' bank, we serve only community banks, not the general public. This unique focus gives me an opportunity to hear and address the business challenges faced by community banks throughout the region.

ICBA believes that the proposed commercial real estate guidance is seriously flawed, and we have strongly urged banking agencies not to go forward with its current form. Nearly 1,000 commenters filed letters with the agencies expressing grave concerns. Many community banks see it as a call to cut back on CRE lending.

If a community bank must cut back, it means cutting back on one of its more profitable business lines, but we fear that it will also lead to an artificial credit crunch in the CRE sector, with less money being available to support community growth. A mentor of mine once said, "You grow your community to grow your bank, not vice versa."

Existing real estate lending standards, regulations, and guidelines are sufficient to guide banks through any weakness in the CRE market, and have already provided examiners with the tools needed to address any unsafe and unsound practices.

Banking regulators state that they have identified problems in some banks, yet they would apply this guidance across the entire industry. Instead, examiners should identify and address these problems bank-by-bank.

The proposed thresholds of 100 percent of capital and 300 percent of capital are seriously flawed; they do not give a clear picture of the risk; they do not take into account underwriting, risk management, and other practices of individual banks; and they do not recognize the different segments of the CRE markets that have different levels of risk. Market analysts could misapply the guidance from these sorts of CRE ratios, giving investors an inaccurate picture of a bank's level of risk.

Community banks conservatively underwrite and manage CRE loans, requiring more and more down payments or taking other steps to control collateral. They must carefully inspect what's going on at all steps of the occasion. They know their community and they know how to underwrite.

I thank you for the time, sir.

[The prepared statement of Mr. McKillop can be found on page 162 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Lackritz.

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION (SIA)

Mr. LACKRITZ. Thank you, Mr. Chairman. Mr. Chairman, Ranking Member Maloney, and members of the subcommittee, on behalf of the SIA and the securities industry, I appreciate the chance to testify today on Basel II as incorporated in the SEC's framework for consolidated supervised entities, and we commend the subcommittee for holding this timely hearing.

As the number of large financial conglomerates has grown steadily over the last several decades, regulators and market participants realized that a form of consolidated supervision was necessary to obtain a comprehensive view of the entirety of a firm's activities and not just individual lines of business. Consequently, a Joint Forum on Financial Conglomerate was formed to focus on the oversight of those institutions, financial conglomerates.

In turn, the European Union's financial services action plan used portions of the Joint Forum's work to develop a directive, the financial conglomerates directive, and that mandates that any financial firm with significant operations in Europe demonstrate that it is subject to and in compliance with a regime of consolidated supervision.

Under the terms of this directive, any non-E.U. firm must prove that it's subject to consolidated supervision by its home regulator that is, "equivalent," to that required of E.U. firms, and a failure to demonstrate that equivalency would require that that firm's European operations would be fenced off or ring fenced, as the term is used, from the remainder of its global activities. In response to this initiative, the SEC undertook to craft a new regulatory framework for consolidated supervision of major independent investment banks not otherwise subject to consolidated supervision; this is so that they could compete in Europe.

Under the CSE framework, the SEC supervises certain broker-dealer, their holding companies, and affiliates on a consolidated basis, focusing on the financial and operational status of the entity as a whole.

Parallel with the requirements of other global consolidated supervisors, the CSE framework incorporates significant elements of Basel II. In reviewing a CSE application, SEC staff assess the firm's financial position, the adequacy of the firm's internal risk management controls, and the mathematical models the firm will use for internal risk management purposes and regulatory capital purposes.

Following approval, the SEC staff reviews monthly, quarterly, and annual filings containing financial, risk management, and operations data on the CSE registrant. To date, the SEC has approved five CSE applicants.

Shortly after publication of the final framework by the SEC in July 2004, the E.U. provided general guidance indicating that the framework is equivalent to the form of consolidated supervision required under the financial conglomerate directive, and with the U.K.'s financial services authority acting on behalf of the E.U., that finding has been subsequently affirmed in its having made equivalence decisions for each of the individual CSE registrants.

We congratulate the SEC on the implementation in a timely fashion of this framework and all the work that went into it. It required an enormous effort by the agency in a relatively short period of time, and we regard it as an excellent example of prudential supervision.

The CSE firms also wish to thank this committee, Mr. Chairman, and members of the Administration, particularly the Treasury, for their interest in learning about the CSE framework and, most importantly, in ensuring the process of finding of equivalency by the E.U. was both fair and timely. That permits our firms to compete globally and specifically to compete in Europe.

Thank you, Mr. Chairman, very much.

[The prepared statement of Mr. Lackritz can be found on page 155 of the appendix.]

Chairman BACHUS. Ms. Petrou.

STATEMENT OF KAREN SHAW PETROU, CO-FOUNDER AND MANAGING PARTNER, FEDERAL FINANCIAL ANALYTICS, INC.

Ms. PETROU. Thank you, Mr. Chairman. It is a real honor to appear before this committee again. It's an honor to appear before you again on the Basel rules, having first been a witness at your first hearing, and to have seen the significant difference in the rules, as under the leadership of you, Chairman Bachus, Ms. Maloney, and the Financial Services Committee, the regulations have changed for the better, particularly with regard to the recognition now of the potential competitiveness impact.

However, as this panel makes clear, there are some ongoing issues which I would like briefly to raise before you.

All of them, I think, are occasioned by the unique nature of the U.S. financial system, and our rules must therefore be crafted to recognize our own reality, not some abstract set of rules devised who knows where sometimes.

We've talked a lot about the risks of different provisions in Basel II. If I may, I'd like to point to another one, which is the risk of the United States staying too long under Basel I. We are now lagging behind everyone else towards adoption of a modern capital framework, and this poses significant risks, not just because of the competitiveness concerns that have been voiced, but actual risk ones.

I would suspect that one of the reasons the banking agencies put the CRE guidance out as is, as you rightly said earlier today, Mr. Chairman, as a blunt instrument, is because we don't have regulatory capital standards that can appropriately distinguish between high risk and low risk forms of commercial real estate, so blunt asset limitations have been proposed instead.

Similarly, I think because our rules do not recognize risk properly, we have seen a huge buildup in high-risk mortgage structures because our regulatory capital system does not well recognize those and the agencies are now scurrying to try to remedy this, in part again because our risk-based capital rules are woefully out of date.

We must move quickly. I think we must adopt as much of the modern Basel II framework as quickly as we can, leaving the disputed pieces aside, resolving those quickly, because again, the longer we stay under Basel I, the greater our competitiveness issues, but even more distressing, the higher the risk our system will run as the business cycle starts to turn.

Now, I know that many of the agencies testifying this morning discussed the leverage standard as one they think will allay some of the risks they see in Basel II.

I believe that that would be a false safety net, and in fact, would make the financial system here riskier if their leverage standard is retained.

This committee well remembers the thousands of banks and S&L's that failed in the early 1990's, and before that throughout the 1980's, when a leverage standard was fully in effect.

A leverage standard, particularly if applied to the parent holding companies, creates incentives to take risk, not to reduce it, because banks must find a way to make regulatory capital and economic capital align as best they can, and an arbitrary leverage standard forces them to take on more risk.

It also forces more reliance on complex off-balance-sheet assets that escape the leverage rule, exacerbating potential risky complexity.

I've testified many times on the operational risk standard. I'd like again to remind the committee that it is an unfortunate aspect of both the Basel II accord and now of the U.S. Basel II NPR. Happily, it is out of the 1A proposal and should stay out.

There is no agreement on methodology or measurement for operational risk and a capital charge will distract banks and supervisors from urgent work to ready our systems, our contingency plans, and disaster preparedness for the manmade, and sadly, for the terrorist risks we must continue to face.

With regard to the standardized option, I would suggest that it be put on the table for U.S. banks. I think it is up to the banks to pick the capital regime right for them, not for the regulators ar-

bitrarily to specify one or another for different types of banks based solely on size.

If the banking agencies do not like the choice an institution makes, they have Pillar 2, safety and soundness, and Pillar 3, market discipline powers to review these decisions and, if necessary, reverse them, but an arbitrary distinction about which capital option should be provided to whom is, I think, top down decision making that exacerbates regulatory burden and competitiveness concerns.

Thank you, very much.

[The prepared statement of Ms. Petrou can be found on page 239 of the appendix.]

Chairman BACHUS. Thank you, Ms. Petrou.

Mr. White.

STATEMENT OF ROBERT M. WHITE, JR., PRESIDENT AND FOUNDER, REAL CAPITAL ANALYTICS, INC., NEW YORK, NEW YORK

Mr. WHITE. Thank you, sir. Thank you for the opportunity to speak to this subcommittee and to address several concerns I have relating to the proposed guidance for CRE concentration risk.

The premise of the proposed guidance is that real estate is among the most volatile of assets, but this premise is faulty. Real estate remains a cyclical business, but it is no longer subject to the extreme boom and bust cycles that were experienced in the 1980's. The capital market for commercial real estate has evolved into one that is sophisticated, transparent, disciplined, and national, if not international, in scope.

Moreover, the transformation of both the debt the equity markets has occurred only recently, primarily in the past decade, and the changes are secular in that they have permanently changed the nature of this industry.

The level of information currently available concerning real estate prices, mortgage terms, development activity, rental rates, and occupancies make the 1980's look like the dark ages.

In the capital markets, this new level of transparency translates into greater liquidity and a diversity of capital sources, many of which did not exist in the 1980's.

For example, real estate investment trusts, or REIT's, while created in 1960, only became a material component of our capital market in the mid-1990's. The growth of the REIT industry has not only expanded the investor base for real estate but brought a whole new level of scrutiny to the industry. In 1990, there were less than a handful of Wall Street analysts covering REITs and the commercial real estate industry. Now there are approximately 500.

The introduction of public capital into the real estate debt markets in the form of commercial mortgage-based securities, or CMBS, has had an even greater influence. The CMBS market helps illustrate that a concentration of CRE loans is not inherently bad if the portfolio is intelligently underwritten and diverse geographically and by property type.

Current subordination levels in the CMBS market approximate 15 percent, meaning that up to 85 percent of the bonds secured solely by commercial mortgages would be awarded a AAA rating.

The proposed 100 percent and 300 percent thresholds do not differentiate between a portfolio that is well diversified and a portfolio that is not.

The CMBS market has also revolutionized transparency and imposed much-needed standards regarding underwriting, documentation, and reporting for commercial mortgages. There is also another aspect to the proposed guidance that troubles me. The 100 percent threshold for construction loans could impede economic growth and restrict capital for new housing and other development since commercial banks are the chief source of construction loans.

Equity of all reporting bank holding companies totalled less than $1 trillion according to the latest out data from the Federal Reserve. However, private construction spending also equates to an annual rate of just under $1 trillion, although construction spending represents only a portion of overall development costs.

Thus, the 100 percent threshold outlined in the guidance would be restrictive, even at current levels of construction activity, and may have unintended consequences of creating a problem where none currently exists.

Thank you for your time, and I welcome any questions.

[The prepared statement of Mr. White can be found on page 281 of the appendix.]

Chairman BACHUS. Thank you, Mr. White.

Dr. Mueller.

STATEMENT OF GLENN R. MUELLER, Ph.D., PROFESSOR, UNIVERSITY OF DENVER, FRANKLIN L. BURNS SCHOOL OF REAL ESTATE & CONSTRUCTION MANAGEMENT AND REAL ESTATE INVESTMENT STRATEGIST-DIVIDEND CAPITAL GROUP, INC.

Mr. MUELLER. Thank you. My name is Dr. Glenn Mueller, and I'm a professor at University of Denver. I have a Ph.D. in real estate and I was called here by the Committee for Sound Lending and the Real Estate Roundtable to help educate you on some of the problems that we have today.

The proposed banking agency guidance on commercial real estate lending concentration appears to be predicated on some fundamental misconceptions of how the commercial real estate industry functions today as opposed to 20 years ago when we had our major problems. Today, the commercial real estate industry is a very different one than existed in the 1980's and the early 1990's.

The real estate asset class has two major groups—residential home ownership real estate and commercial income-producing real estate such as office, warehouse, retail, apartment, and hotel.

Residential real estate markets and commercial real estate markets are fundamentally different. Residential ownership, housing, is not connected or highly correlated with commercial income-producing real estate.

The commercial space market is local in nature, driven by local employers for demand and builders for supply. Demand and supply drive occupancy rates that drives rent growth. Occupancy rates and rents drive earnings that make mortgage payments.

The real estate space markets today are different for every metropolitan market, for every major property type. Thus, a Chicago

office market and a Chicago retail market are in very different places in their cycles and the Chicago retail market is in a very different place from the Miami or New York retail market.

In my written testimony, I have a copy of the market cycle report that I do on a quarterly basis that goes out to most people in the industry, that explains those differences.

The space cycle of the 1970's was 10 years long, peak to peak, while the next cycle was 21 years long, 1979 to the 2000 peak. The current economic space market hit an occupancy bottom in 2003, but price declines and loan defaults did not happen in this down cycle as they did in the 1990's.

Today's space market is still in the recovery phase for most property types and probably won't peak until after 2010. The growth phase of this cycle probably doesn't start until 2008.

The severe cycle downturn that occurred in the commercial real estate market during the 1980's and early 1990's was triggered by factors that are not present in today's environment, such as the changes in the internal revenue code that allowed people to make tax investment and tax shelter deals.

These deals were not based on underlying profitability of the project as well as we had expansion of lending powers to thrifts that allowed commercial real estate loans to be made for the first time by people who were inexperienced in the marketplace. These factors led to over-building. Then regulatory guidance in the early 1990's shut down all capital flows to commercial real estate and the problem was exacerbated, and hurt a healthy real estate industry for many owners with good properties.

The agencies should gain a better understanding of the changes in the marketplace today and develop guidance that addresses the diversity and low risk of today's real estate. They should also consider an analysis of property type and metropolitan area concentrations when they analyze risk.

We hope that the committee will think about, or rethink, the need for these arbitrary thresholds that they are proposing.

Thank you.

[The prepared statement of Dr. Mueller can be found on page 214 of the appendix.]

Chairman BACHUS. Thank you.

Mr. Hensarling, thank you for your attention on this matter, and for your involvement. It's been invaluable.

Mr. HENSARLING. Thank you, Mr. Chairman. I offer an apology to almost every witness. I was on the Floor engaged in debate and frankly missed most of the testimony. I think I heard about half of yours, Mr. White, and much of Dr. Mueller's, which actually hit upon a key point that I wanted to explore with our regulators and ran out of time on the earlier panel. And that is really to compare and contrast the underlying conditions in our risk assessment tools we have today vis-a-vis roughly 15, 20 years ago, in the late 1980's and the early 1990's.

One thing I guess I heard you say, Dr. Mueller, which rings very loud to me, is that there was a lot of real estate that was built that was essentially tax code driven, and to me that is obviously a very fundamental difference we have in today's economy versus that which preceded the real estate bust of that time.

But I'd be curious in exploring with any of the other witnesses, as we get concern from the regulatory community, what is it that your industry is doing differently today than it was 15 years ago that should somewhat ease the concerns of members of this committee? How do we know it's not going to be "deja vu all over again?" Whoever would like to hop in.

Mr. MCKILLOP. I'd love to give it a try. In relationship to community banks, we are seeing that there is a much, much closer correlation to the banker understanding cash flow needs of the borrower, the cyclical needs of that borrower, and their capacity to pay.

The community banker goes to church and the Rotary Club and the grocery store with these folks that they're making loans to. It's not mystique. But in this cycle, we are not driven by a tax-laden incentive to get things going.

We have been driven, however, by a low interest rate environment, which helped spur the economy out of the economic decline following 9/11, which recognized that was the case.

The Federal Reserve led us to very low interest rates. It spurred the economy along as prime dropped to 4. Prime is now back up to slightly above 8. And that helped the economic cycle. There will be some repercussions from negative cash flow as interest rates have gone higher.

But the bankers are understanding the valuations, they're taking strong loan to value precautions, they are taking a guarantor or a co-borrower position behind the collateral in addition to that and monitoring on a monthly or quarterly basis.

Mr. HENSARLING. Anybody else?

Mr. LACKRITZ. Yes, Congressman. We don't have a direct dog in this particular fight concerning real estate loan regulation, but talking about the capital markets and how that's changed significantly over the last 15 years, I can speak to the evolution of deep, rich, liquid capital markets that in fact help to finance all the mortgages and real estate loans that end up being made.

While they're made at the front end by the banks, they end up being laid off back into the capital markets and sold in the capital markets and securitized, basically. And the capital markets have grown dramatically in the last 15 years to provide additional liquidity to the sector, but in addition to that, with the evolution of financial engineering, portfolio theory, and a number of other factors that go into managing risk more effectively, there are far better products in the marketplace now to hedge that risk. There are structured products to in fact try and provide some balance and some risk.

And so while you've got evolution of technology and you've got evolution of marketplaces, you still have human nature, which hasn't changed, and which will still cause boom and bust cycles, but I think the capital markets have evolved in such a way that it helps to cushion those ups and down a lot more significantly than they used to.

Mr. HENSARLING. I'm being mindful of my time, and wanting to slip in at least one more question.

Dr. Mueller, did you have one quick comment?

Mr. MUELLER. Yes. Very quickly. In 1990, there were very few real estate programs in the country. Today there are over 30 of them. We have 500 students at the undergraduate and graduate level in our program. We have people who are well-versed and understand the marketplace.

In the 1970's, when I first went to work for a bank as a loan analyst, there were no standards for appraisal. Now we have appraisal licensing.

And many times, banks didn't even have good information about the loans that they had made when they went bad. Today, we have much better standards and much better underwriting and we're underwriting economic deals that actually have tenants and leases in place.

Mr. HENSARLING. A second question.

As I listened carefully this morning to the chairman of the FDIC, I thought I heard her say that with respect to the CRE guidance, that we do not have limits, we just have increased scrutiny. I'm not sure all the bankers in my district feel thusly.

Do you feel that there is a de facto limit out there, and if so, what evidence do you have of it?

How about you, Mr. Simmons?

Mr. SIMMONS. I guess I'd say that we found regulators, starting about 3 years ago, really focusing on commercial real estate concentrations.

We are very active through the Southwest, Texas, Arizona, Nevada, and Southern California, where it's a major activity, and I'd say first of all, to their credit, they have focused on strengthening risk management, and I think the industry is doing a much better job of that.

But I do think that there is a risk when you try to get the word down to the examiners in the field, that it does turn into a very prescriptive kind of approach that has a risk of really shutting off credit to projects that are deserving of credit.

And so that's—you know, we have yet to see how this will play out, but I think we're all nervous about the possibility of it really becoming a great tightening.

Mr. HENSARLING. With the chairman's indulgence, could the other panelists answer the question?

Chairman BACHUS. Yes, sir.

Mr. MEYER. Mr. Hensarling, I would just add to that, not something different, but just a slightly additional perspective. And that is that, in the hands of an examiner, the tendency is to interpret guidance from Washington in the most severe fashion, and as I read through the guidance, in fact, I used a highlighter, because they make a very grand distinction between the word "should" and the word "must," which on a regulatory basis has significant implications.

If you count the number—I gave up. My yellow highlighter was wearing out in terms of the number of "shoulds" that were contained in the guidance. And I'm afraid what happens in the real world is that the examiners tend to read that as "musts," the "shoulds." Also, I would say that beginning with an examination which we were undergoing when this guidance was first issued on a proposal basis, that the examiners who were examining our insti-

tution immediately started evaluating our performance using the thresholds outlined in the guidance, and while we protested, they said, "You might as well look at it from this perspective, because here's what's coming."

So I think the real world application may be different from what is intended in Washington.

Mr. HENSARLING. Did anyone else wish to address the question?

Mr. MCKILLOP. I've been through an examination. I have 270 banks that I work with. Since January when these guidelines went out, every banker that I've spoken with has been directed to be using the new guidelines. My most recent exam used the guidelines in August.

Mr. HENSARLING. Thank you. And I am very much out of time.

Chairman BACHUS. Thank you.

Ms. Maloney.

Mrs. MALONEY. Thank you. I thank all of you for your insights. I'd like to ask Mr. Garnett, on the QIS–4, it led the regulators to add their additional safeguards to the U.S. version of the accord. And my question is, do you think the QIS–4 is an accurate measure of risk?

Mr. GARNETT. The direct answer to your question is no, and I think we probably heard that same answer from at least one or two of our regulators this morning, and let me describe why that is the answer.

The QIS–4 was performed long before the practices in the various banks were in compliance with Basel II. We're still working on that as we speak. As I think Comptroller Dugan mentioned, there was no supervision to that exercise.

Most importantly, there was no assessment of what we call Pillar 2, and that is a very important part of the Basel II process. This is the supervisory examination process where they sign off on your process. So I would describe QIS–4 as a dress rehearsal without the director in the house.

Unfortunately, we've drawn some conclusions, or conclusions may have been drawn from that and have resulted in adjustments to the advanced approach from the Basel accords which are obviously now causing us some very serious competitive and cost burden concerns.

Mrs. MALONEY. Would anyone else like to comment?

Ms. PETROU. I would. I would strongly agree with that. Indeed, initially, the regulators expected that the QIS–4 exercise would be very flawed and they intended to have supervisors at everybody's side, double checking all the entries. That quickly became impossible and the survey results are just wholly unreliable as a result.

Mrs. MALONEY. I'd like to ask you, on your earlier statements, you said, Ms. Petrou, that many of the industry—and you—stated and others stated that the fact that the United States is behind other countries in the implementation of the Basel II accord would put U.S. banks at a disadvantage. And can you quantify that? In other words, to what extent should we value implementing a rule quickly over making further adjustments?

Mr. MCKILLOP. I think it's impossible to quantify, because you're really asking me to judge when is the search for the perfect the enemy of the good. And I think the Basel exercise, from its incep-

tion, when your committee first held these hearings in 2002, until now, has often been one in which model builders wrestle each other to the ground on what a probability of default is on a Tuesday, and the larger scheme gets lost.

I was very honored to testify before this committee last year that a lot of Basel debate has been among the "how to" people, both in the regulators and in the banks, and the "should we."

What does it mean for a financial system debate is only now coming out as again your committee has forced the regulators and the industry to really confront these issues.

If foreign takeovers occur in the United States, or we have bank non-bank takeovers where institutions decide to lose their banking charters because they see this as a necessary market evolution, so be it, but if we have further consolidation or similar changes, more non-bank charters, for example, creating new risks solely because of an arbitrary regulatory capital charge, that I think would be a most unintended consequences of the search for the perfect capital accord.

Mrs. MALONEY. Building on what you said, are there parts of the accord that could be adopted now while leaving room for further adjustments, and would that make sense?

Ms. PETROU. With modifications for the United States, yes. For example, the operational risk-based capital rule is ill-designed and inappropriate around the world, and we should not impose it here, especially in light of the many non-banks that are key competitors in segments like asset management, and our leverage rule is problematic for the same reason.

I would note that the SEC did not impose a comparable standard in the CSE charter, so big commercial banks like Citigroup are on day one against a competitive challenge with big investment banks like Goldman Sachs, as a result.

Mrs. MALONEY. Going to another point, I was really shocked at the testimony this morning by some of the regulators where they, if I heard them correctly, they said that if there were any problems, then they'd let the international community work it out. Now, I don't see the international community trying to protect the American financial interests. I found that very troubling.

I also found it very troubling where no one would affirm or come forward—I said, are American banks disadvantaged in the capital requirements, and I got the impression that, "Yes, but don't worry about it, the international community will work it out." Now, I found that a troubling statement, but I invite anyone on the panel to make a statement on it, or do you trust the international community to work out any problems that may be disadvantaging the American financial institutions?

I'll go to Mr. Garnett. I'll pick on him, since he's my constituent. But I really invite anyone else to make a statement. But I found that, quite frankly, a shocking statement.

Mr. GARNETT. I think the approach to fixing a significant problem that is unearthed, and quite frankly, I have yet to be made aware of a significant problem that can't be corrected through the powers that the regulators have been granted in Basel II, particularly through Pillar 2.

But if there is a particular flaw that is found after a period of time, we would obviously prefer that flaw be fixed universally, so that we don't find ourselves with an uneven or a disjointed regime for regulatory capital.

I think that's about all I can add to your thought.

Mrs. MALONEY. And if I could add to it, there's significant differences between the proposed U.S. version of the accord and the version being implemented in the E.U. and other countries. I don't understand why we have this difference.

But there's a different implementation schedule, there are overall more conservative rules leading to a harsher decision, no choice of compliance methods. There's artificial definition of default not consistent with current banking practices. These are a few differences that we pulled out, but why should we have these differences?

As you said in your testimony, Mr. Garnett, why don't we harmonize it and move forward so that everybody is on a fair playing field and that everybody has a competitive equality?

And my question to you, we should not put our banks at a disadvantage to foreign banks. At the same time, I am concerned about safety and soundness, and is it possible to strike a balance between these two policy issues? And again I'll start with Mr. Garnett, and if anyone else would like to add anything.

Mr. GARNETT. As you stated, in our testimony, we think it's extremely important to be operating from a consistent set of standards.

Again, if there appears to be a significant flaw in those standards, I think that flaw ought to be resolved within the Basel community at large, so that if there are—I am not aware of any significant flaws. We are implementing as we speak, as a company, in many locations, and we are not at this point aware of any significant concerns that are being raised to us with regard to this implementation. So we feel, obviously, very comfortable with the safety and soundness. That was a critical, critical piece of the objective of Basel II, safety and soundness, and I want to underscore that, in level of importance.

Chairman BACHUS. I thank the gentlewoman from New York.

Let me start by saying that the risk management procedures at banks must be working, because I don't think we've had a bank failure—we're at historic lows. No, we've had, you know, much advertised busting of the residential housing market in certain areas, although as the testimony has been, you know, it's different from area to area. But the banks are obviously doing something right.

The regulators—the present regulatory scheme must be pretty good. That having been said, what is proposed—let me ask the bankers, I'm going to start with the bankers. This question will go to Mr. Simmons, Mr. Meyer, and Mr. McKillop.

What the regulators are proposing as far as the regulatory model that they're setting up under Basel, how does it fit with the present-day banks' procedures, risk management procedures? Would it force a change in what you're doing, and what would be the cost or the result of those changes?

Mr. SIMMONS. Thinking about different sizes of banks, I think you'll find that the very largest banks are well down the road toward developing economic capital models and risk management

systems that are very compatible with the concepts underlying Basel II. As you get to community banks, that would be less the case.

But nevertheless, I think the standards have risen across the board, over the last couple of decades, since we last had some real problems in the industry, in terms of the structure internally in institutions, the risk management checks and balances, and appraisal review functions as it pertains to commercial real estate, etc.

But it's important, I believe, that we have options, that the very largest banks have a regime that's compatible with their complexity and the work that they've already done, and that the community banks, that we not add to the regulatory burden.

At the same time, we believe that it's really important that we not create capital allocations and charges for different classes of assets that vary by size of institution.

So at the end of the day, I think it's going to be really important that we allow every size bank to apply the same type of capital charge to the same type of asset. Otherwise, you're going to find a great deal of arbitrage, shifting of market share, and I think a great deal of risk that will arise as a result of that. So that's going to be important as we build new capital frameworks going forward.

Chairman BACHUS. Mr. Meyer.

Mr. MEYER. I'm not sure that I would differ with anything. I would like to re-emphasize the point about similar charges for similar assets. I think that's terribly important.

I think what's going to happen, and I think what has happened, as Harris was saying, is that we have seen a vast improvement and change in modeling that banks do in their risk management practices, and I think that is universal, to a higher degree perhaps in the more sophisticated larger institutions, and if you get to the smaller community banks, less so.

But nonetheless, it has been a subject of concern and interest for virtually everybody, and I think that the longer the good times have gone on, and we've all enjoyed some pretty good times, I think that the degree of scrutiny within institutions has risen because we all realize that good times don't necessarily last forever.

I think that the opportunity to have a bank choose the system that best fits its business model and its risk parameters from having available to them in the future Basel I, IA, and having the advanced approach as well as the standardized approach, it fits what I think institutions are gravitating towards, and that is, choose the model that best fits your institution and your risk model, your risk parameters going forward as an institution.

And I think universally that will tend to strengthen the risk management practices even further than it has in the past, as people have broader opportunities.

Chairman BACHUS. Anyone else?

Mr. MCKILLOP. Yes.

In trying to speak for community banks, I'd have to say that there is a tremendous uncertainty in regard to whether or not it's going to make sense for a $100 million or $200 million or $300 million bank to spend the money necessary on the computer side of the business, which they don't own—they don't have the DP system

inside, they don't have the programmers inside. They have to go out to an advisor and get a program written and get it run and pay for it—the tradeoff. Where's the tradeoff? I'm going to spend $100,000 for this program to get $10,000 more in revenue, or not?

So the community banker really needs the opt-out provision, the capacity to keep running like they're running right now, as long as they're well-capitalized and well-managed. If, down the road, there is a clear and directed economic bias that says that if I adopt these standards, I can make a better business plan, then that community banker could opt-in. They're smart enough to be able to do it, and hey're independent enough to want the choice.

Chairman BACHUS. All right. And Mr. Garnett, the larger institutions, do you have any comment on this?

Mr. GARNETT. As far as we're concerned, the most effective way of managing cost burden, or cost benefit we should be thinking about, and level playing field, competitive marketplace, is permitting options that fit the right shoe.

And I think by having on the table Basel I, Basel IA, standardized and the advanced, and of course those last two approaches need to be consistent with the international accord, I think provide the marketplace here in the United States with the right balance of options.

Chairman BACHUS. All right. If we had not only advanced but a standardized approach option, would it in many cases for the banks—and I'll ask the bankers this again—would it reduce the cost, or what would be the—what do you see as a cost prediction?

Mr. MCKILLOP. If I could just start, the standardized option is clearly easier to adopt.

Chairman BACHUS. It's more cost-efficient?

Mr. MCKILLOP. That's correct.

Chairman BACHUS. And the smaller the bank, the more difference—

Mr. MCKILLOP. The more likely that they would move in that direction.

Chairman BACHUS. Mr. Simmons?

Mr. SIMMONS. Yes, I would agree with that. The standardized approach is going to be much more cost-effective and lead to approximately the same kind of result.

Chairman BACHUS. Thank you. Let me shift to the analytic and our academic witnesses.

I guess, Mr. Mueller, what you said is something a lot of people don't appreciate. I think they lump real estate together. They talk about a bubble, and they'll be talking about a residential housing bubble; in another place, there may be an overabundance of commercial property or over-building.

But I would think that really, the people who can make the best judgment of that would be the local institutions that are loaning their money, as to whether it's profitable.

I think that if you're a local bank, you're going to make a judgment on whether you think you get your money back, and it probably depends more on who you're lending it to and how deep their pockets are, and they may even lose their investment, but at least they would probably pay their loan off.

But I just—what would you—I read your testimony. Would you elaborate on the difference in the residential market and commercial market again?

Mr. MUELLER. Sure. I guess one of the key things is that a residential loan to a homebuilder has a risk to it that, when the house sells, the bank gets paid off.

In commercial real estate, and I put apartments in the commercial real estate income-producing category, you basically pre-lease space prior to building, and therefore you know that you have revenue coming in that will help pay the loan. As a matter of fact, of all the property sectors, of all the commercial property sectors, apartments have shown to be the least volatile of all the property sectors in history, and yet they're very different, and let me give you an example from my recent quarterly report.

Orlando, Florida, has an apartment vacancy rate that is under 2 percent today. It is one of the strongest apartment markets in the country, because obviously the economy is doing well. A loan to an apartment building in Orlando would be perceived to be extremely low risk.

On the other hand, if you look at Hartford, Connecticut, their vacancy rate is above 10 percent, and it's not a community that's growing, it's not a community that needs more apartments, and therefore a new building in Hartford, Connecticut, probably is not economically justified.

Banks know that. Banks can look at it and say office buildings today can't be built unless at least 50 percent of the space is preleased. That's pretty standard in the banking industry today, so there is much better understanding of what's going on.

Banks, when they are doing larger loans, typically will syndicate participations to other banks so that they aren't just concentrated in their own community, they actually are spread out.

They can also sell their commercial loan if they're making a permit mortgage into the commercial mortgage-backed securities market and buy back the same amount of loan in the CMBS market that is a pool that's diversified across the country.

So what happened in the early 1990's is very, very different from what's happening today.

Chairman BACHUS. I think in your testimony you mentioned that the Middle Atlantic region consists of both Washington and Philadelphia, although those markets right now are diametrically opposed—

Mr. MUELLER. That is correct—

Chairman BACHUS.—their characteristics.

Mr. MUELLER. That is correct. As a matter of fact, even here locally, the downtown Washington, D.C., market is literally the best in the country, and yet if you go out west towards Dulles Airport, that market, that sub-market, if you will, is still kind of coming through recovery and just beginning to go into growth. So even by sub-market, there can be major differences.

Chairman BACHUS. How do you generally define a CRE market? Is it a region? Is it a State? Is it a city?

Mr. MUELLER. It's typically done by metropolitan area, is the way that most people look at it, because the base industries that

drive employment growth, for instance, between Seattle, Washington and Detroit, are completely different.

As the oil industry goes, so goes Detroit, but Seattle is done by both technology and the airline and aircraft building. So metropolitan areas are driven by the local economics and employment, and the commercial property types follow those cycles, and that's why in the report it shows that they're very, very different.

Chairman BACHUS. But even a bank examiner trying to determine a threshold or a cap could make a mistake reviewing a loan portfolio.

Mr. MUELLER. Right. Well, I think if they looked at diversity of loans within different metropolitan areas and just by different property types as well—you can have a very good market for apartments in Chicago, but a not-so-good office market, and so the different cycles by property sector make sense.

I think one of the biggest problems is that regulators and the general public, when they hear real estate, they think of that one thing, or the past 2 years every time, and on a weekly basis I get a call from a reporter, "Will you give me some quotes for the real estate bust?"

And my first question is, "Do you understand that there is a difference between the residential home ownership and the commercial real estate market?"

Chairman BACHUS. Okay. Mr. White, you mentioned the condo converters. We obviously—I have a property on the Hill, and I'm constantly getting letters from these converters asking to buy my property. And I've noticed the regulators have actually expressed some concern about that.

But, you know, in my opinion, it actually adds liquidity to the market, and I'm not getting as much—they've adjusted pretty well to the market, because I used to be getting two or three, you know, a month, and now I'm getting maybe once every—it's been probably 2 months since I've got a solicitation. But would you comment on that?

Mr. WHITE. Sure, I'd be glad to. The condo conversions reached a frenzied pace about a year ago. It was truly an area that everyone in the industry was looking at, and if there was a bubble in the commercial sector, it would probably be in that area, and the lending to the condo converters was the most aggressive out there, throughout the industry.

But while we are all looking at that, and thinking back to the 1980's, it actually turned out to be a great example of the lender discipline that's out there.

At the first sign that the housing market started slowing, condo conversion activity started to slow down, and it has come to almost a complete standstill in just a matter of months, and that is really a result of lender discipline out there.

Chairman BACHUS. So a lot of efficiency in the market is what you're saying?

Mr. WHITE. Very much so.

Chairman BACHUS. Okay. Based on your research, do you see a bubble in the commercial real estate market?

Mr. WHITE. Absolutely not. I don't. Prices, if you look at them, on a relative basis, relative to replacement cost, are still very much

in line. Construction costs have been rising as fast, in fact faster, than properties have been appreciating.

The yields on real estate, while low, and almost low on a historical basis, the spread between yields on real estate and 10-year Treasuries, that risk premium there is not the lowest that it's been. There's still a healthy cushion there. I see the buyers and the investors being very rational.

Chairman BACHUS. Let me conclude. And this is not so much a question, but if anybody wants to respond to this bit of philosophy, they can. I know Mr. Hensarling, I know where he comes from, so I know he'll agree with me on this.

But one of my greatest problems with these guidelines is that I think unintended, in an unintended way it will cause—it may cause banks to shift their lending pattern to comply with what the regulator wants them to do as opposed to what the market dictates, which could have consequences for the economy. It could actually dry up lending in an area where lending ought to occur.

And I'm not sure that the government should be in the business of telling a bank where it ought to loan money. What I think it ought to be in the business of doing is reviewing the portfolio to see that it's sound and the default rate is low, and that each loan, on itself, is—or the percentage of loans are good loans. Any response to that?

Mr. MCKILLOP. I would just like to respond from the standpoint that CRE guidance has for the first time a capital kicker, a requirement, a possible requirement for capital.

There are no other regulations or rules promulgated that direct the necessity of additional capital. The regulators have all the tools necessary to take care of these various aspects of CRE and portfolio management and risk control. The addition of this capital component really is quite bothersome, especially without clear guidance on how it would be administered.

Chairman BACHUS. Do any of you share my concern that it could actually drive the type of lending by the banks? And I'm not talking about, if they're concerned about interest only, or certain types of loans, or the number of adjustable rate mortgages, I can see that as a valid concern.

But to tell banks that they may have too many commercial loans or too many residential loans, in and of itself, as long as those loans are being repaid, is to me an unnecessary intervention. Is this an imaginary fear on my part or is there any basis for it?

Mr. MCKILLOP. No, sir, it's not imaginary. Out of about 270 banks, 10 percent have modified their policies and procedures implementing those caps and, in essence, mandating a change in their policies on where they are going to put loans.

Mr. MUELLER. If I may, you know, just a historic example. Back in 1991, when basically the banking regulators said, "No more real estate loans, period," there were many very profitable, good companies. ChemCo would be one example out of New York City.

It forced them to take their company public to get capital to pay off bank loans on loans that they had never missed a payment on that were in complete compliance, but because there, you know, was a 10-year loan that was coming due, and the bank couldn't redo the loan. They were forced by the regulators to foreclose on

them and get out of it. It did change the real estate industry because of that.

But that kind of thing potentially could happen again, and in many cases, it's a very unintended consequence.

Chairman BACHUS. Thank you. I've been advised that we only have about 5 minutes left on the vote.

Ms. Maloney.

Mrs. MALONEY. I think you've raised a lot of issues that really merit another hearing on how financial policy impacts on the real estate industry, in many cases unfairly, in driving the markets.

But fundamentally, this hearing is about Basel II and where we go from here, and I would like to ask the panelists, what's the next step?

Chairman BACHUS. Let me say this. What you can do is, we can direct a question to them, if that's okay.

Mrs. MALONEY. Okay. I'm directing a question right now.

Chairman BACHUS. All right, go ahead. Well, let me—

Mrs. MALONEY. If i could just say that it's clear that, from the testimony today, that the standard is a higher standard in capital requirements for the American financial institutions, which I think is unfair in a global market.

We as a Congress, as a country, as a Federal Reserve, should be fighting to have our financial industry on the same playing field.

But what we've heard today is that there's a different standard, a stronger standard, a higher standard for American financial institutions. I think that that's unfair. And we should be fighting to make sure that our institutions can compete fairly and equally. And so my question is, what is the next step? Where do we go from here? I hope that the Federal Reserve and the committee that is working on this will listen to the testimony and make the proper adjustments as we go forward in the implementation of moving forward with Basel.

I welcome any comments, and maybe you should send them to me in writing, because I'm going to miss a vote if I don't go.

Chairman BACHUS. Thank you, Ms. Maloney. And I'll just conclude by this: I think what she asked is the very essence, where do we go from here?

I would start by saying that this hearing has been very valuable. I think it's highlighted the need to develop a greater consensus on how to regulate particularly real estate commercial lending. I think Mr. Frank got to the bottom line in noting that the regulators need to be careful in defining their buckets and what should go into them.

I would encourage the regulators to meet with some of the panelists—Dr. Mueller, Mr. White—in the process of refining their guidance, as well as with the bankers and the industry.

The market seems to have changed significantly, and we want to make sure that the bankers understand that, understand the market as it exists today, and not as it existed in the past.

Given their expertise and the experience in the commercial real estate market, I think this panel could play a significant role in further defining and advising the regulators as they develop the guidance.

So I, for one, am going to try to encourage some discussion between the first panel and the second panel. So with that, I will conclude.

That has been my basic policy as a subcommittee chair, is to try to get the parties together, and to communicate, to resolve some of their differences, if they can.

I'm going to discharge this panel, but before I do so, I have to do two or three bookkeeping things.

I'm going to introduce testimony—I see no objection—the institutional risk and analytics testimony—a statement by the Risk Management Association and a statement from the Real Estate Roundtable.

The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

This hearing is adjourned.

[Whereupon, at 3:21 p.m., the hearing was adjourned.]

A P P E N D I X

September 14, 2006

OPENING STATEMENT OF CHAIRMAN SPENCER BACHUS
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
"A REVIEW OF REGULATORY PROPOSALS ON BASEL CAPITAL AND COMMERCIAL REAL ESTATE"
SEPTEMBER 14, 2006

Good morning. Today the Subcommittee on Financial Institutions and Consumer Credit holds its sixth hearing on Basel Reform since the 106th Congress. Today's hearing will focus on the current status, recent developments, and potential impact of proposals from the financial regulators on Basel capital reform and commercial real estate lending guidance.

The goal of Basel is to develop a more flexible and forward-looking capital adequacy framework that better reflects the risks facing banks and encourages them to make ongoing improvements to their risk assessment capabilities. Over the past seven years, United States federal banking regulators have been engaged in negotiations with their foreign counterparts about improving the standards that govern the capital that depository institutions must hold against their assets.

The Federal Reserve Board, as the U.S. central bank, has taken the lead on this issue for the U.S. banking regulators. I would like to thank Governor Susan Bies for her dedication and hard work on the Basel Accord. Governor Bies has created an

open dialogue with Members of Congress and the financial services industry. She understands the concerns that members of this Committee have raised with past proposals and has worked diligently to address those issues. Under Governor Bies' leadership, the banking regulators have worked to build consensus, and I would like to commend all of them for their efforts to improve the Basel framework.

We must ensure throughout this process that we do not include a framework that is too complex or costly to be followed. There are a wide variety of views expressed in the testimony that we will receive today. On the one hand, the federal banking regulators will testify that they have developed a Basel II rule that is intended to produce risk-based capital requirements that are more risk-sensitive than the existing rules. On the other hand, industry witnesses will tell us that the current U.S. version of the Basel II rule is less risk-sensitive than the internationally negotiated Basel II Accord, and that the differences between the U.S. rule and the Accord creates serious competitive issues, both within and outside the United States. This suggests that more work needs to be done on the rule. I was pleased this month that the regulators met and approved the notice of proposed rulemaking (NPR) on Basel II that requested comment on whether the so-called core banks and opt-in banks should be able to use the standardized approach. Alternative compliance options

are a feature of the original Accord, and banks outside of the U.S. are provided this option.

In addition to the issues arising from Basel II, our hearing today addresses a January 2006 interagency Guidance on Concentrations in Commercial Real Estate (CRE) proposal by the banking regulators. The proposal seeks to address high and increasing concentrations of commercial real estate loans at some banks and savings associations. The agencies suggest recent examinations show that risk management practices and capital levels of some institutions are not keeping pace with their increasing CRE loan concentrations. In turn, the Guidance sets forth thresholds for assessing whether an institution has a CRE concentration and should employ heightened risk management practices. The Guidance urges those institutions with elevated concentration risk to establish risk management practices and capital levels commensurate with the risk.

Some institutions have expressed the concern, however, that the proposed Guidance is too much of a "one size fits all" formulation and is effectively a cap on commercial real estate lending. They instead urge that the regulators utilize the examination process that identifies lending weaknesses in particular institutions. They contend that the data does not support the proposition that real estate lending *per se* is more risky than commercial and industrial lending, for example.

Further, there is concern that the proposed Guidance is unfairly burdensome for community banks that do not have opportunities to raise capital or diversify their portfolios like larger banks. It is my hope that by the end of this hearing we may all be working from the same set of underlying facts with respect to how the real estate market works. In turn, I would hope that this will help ensure better regulation that will protect the taxpayer while not arbitrarily discouraging sound lending.

In closing, I want to thank Chairman Oxley, Ranking Member Frank and all of the Members of this Committee for their interest in working to ensure the Basel Accord is adopted in proper form. I look forward to hearing from our witnesses today and I am now pleased to recognize the Ranking Member, Mr. Sanders, for an opening statement.

September 14, 2006

Opening Remarks Representative Maxine Waters, D-35th CA

Subcommittee on Financial Institutions and Consumer Credit

Hearing on

"A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate."

Good morning ladies and gentlemen. I would like to thank the Chairman of the Subcommittee Mr. Bachus and the Ranking Member Mr. Sanders for holding today's hearing, "A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate."

The 1988 Basel Accord, or Basel I, is the basis for our banking system's current risk based capital standards. However, by the 90's the Basel I risk based capital standards were no longer applicable to the risks being taken

by within the banking system, particularly by our large money center banks. In other words, these banks outgrew the Basel Accord. In response to these circumstances, the Basel Committee initiated efforts to move towards risk-sensitive capital practices by adopting the Basel II Framework. Our regulatory authorities support Basel II, which include the advanced internal ratings-based approach (IRB) for credit risk and the advanced measurements approaches (AMA) for operational risk. In fact, we are in the 120 day comment period for proposed rules related to Basel II, and 12 major U.S banks would be affected by the new risk based capital rules.

I agree with the concept of aligning our capital requirements to the actual risk being taken by our banks, particularly for the larger banks. On then other hand, I am concerned that the rules promulgated take into

consideration the concept of flexibility. That is, the capital rules must be tailored to fit the complexity of the bank's risks. Other banks in the system should be able to rely on less advanced approached to risk than their larger counterparts. In any event, I believe that the proposed rules must ensure that we protect the safety and soundness of our banking system. I understand that the rest of the world has gravitated to risk based standards, but are we implementing a risk-based capital framework for the U. S. banking system that represents best practices? I hope that the testimony will shed light on this question.

The focus of today's hearing is also on the rapid growth in commercial real estate loans held by some banks. According to recent published reports, commercial loans increased by 16 percent in 2005 to $1.3 trillion. In response to the growth in commercial real estate lending,

federal regulatory authorities, including the Federal Reserve issued draft guidance in January. In effect, the proposed guidance would have banks that exceed certain levels of lending in construction and commercial real estate to increase risk monitoring or add capital. Alternatively, banks could be required to increase their capital, as well as monitor risk.

What is at issue here is a possible repeat of the financial crisis of the 80s and 90s where commercial banks savings and loans with bad real estate loans suffered losses beyond the absorption capability of the system. The former Resolution Trust Corporation had to be created to deal with the liquidation of assets of 1100 banks and 1000 S&Ls from 1987 to 1994, costing the American taxpayer billions of dollars. No one wants to see a repeat of that crisis. And no one wants to overreact to these investments, lest we

send signals to the financial markets leading to what some observers warn would be a "credit crunch." However, if the regulators have identified a potential problem within the financial services industry related to bank investments in commercial real estate then we need to listen to what they have to say.

Are the small banks being to aggressive in their lending practices? If they are, will the end result be beneficial to the economy, or will these practices result in bank losses and closures. In the last several years, we witnessed the incredible run up in the price of residential real estate in many regions of the country. As the market settles we know that many homeowners have mortgages that are higher than the equity in their homes. If this phenomenon is duplicated in the commercial real estate

market how will it affect the overall integrity of our financial system?

There are as many as 1/3 of our national banks with 300 percent or more of their bank capital concentrated in commercial real estate. One bank has commercial real estate loans that represent "750 percent of, or 7.5 times, its capital." Is this prudent banking practice, or is it inherently risky? I welcome the witnesses and look forward to their testimony. Mr. Chairman. Thank you.

TESTIMONY OF

STEVEN L. ANTONAKES

MASSACHUSETTS COMMISSIONER OF BANKS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

REGULATORY PROPOSALS ON BASEL CAPITAL AND COMMERCIAL REAL ESTATE

Before the

FINANCIAL SERVICES SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

UNITED STATES HOUSE OF REPRESENTATIVES

September 14, 2006

Room 2128, Rayburn House Office Building

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.

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

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

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

September 14, 2006
Room 2128, Rayburn House Office Building

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.

The Importance of Capital

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.

Interagency Guidance on Concentrations in Commercial Real Estate Lending

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

[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.

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Statement of

Susan Schmidt Bies

Member

Board of Governors of the Federal Reserve System

before the

Subcommittee on Financial Institutions and Consumer Credit

Committee on Financial Services

U.S. House of Representatives

September 14, 2006

Chairman Bachus, Representative Sanders, and members of the Subcommittee on Financial Institutions and Consumer Credit, I thank you for the opportunity to discuss the developments relating to bank regulatory capital requirements in the United States, including the U.S. implementation of Basel II and updates to regulatory capital rules for market risk, as well as the regulatory agencies' proposed guidance on commercial real estate (CRE) concentration risk.

Developments Related to Regulatory Capital Requirements in the United States

As Subcommittee members may know, last week there were some very positive developments in the process to revise regulatory capital requirements for large, internationally active U.S. banking institutions. First, the Federal Deposit Insurance Corporation board approved the Basel II notice of proposed rulemaking (NPR) on the advanced capital adequacy framework, commonly referred to as Basel II. At the same time, the FDIC board approved an NPR that would update the U.S. regulatory capital rules for market risk exposures. The Office of the Comptroller of the Currency and the Office of Thrift Supervision took similar actions on the same day. Together with the Federal Reserve's approval of the draft Basel II NPR in March and the market risk NPR in August, these steps complete all necessary approvals for the two NPRs to be published in the *Federal Register* for formal public comment. Proposed templates for regulatory reporting requirements associated with the two NPRs will be published in the *Federal Register* for comment at the same time.

Regarding market risk exposures, that NPR is based on a set of revisions developed jointly by the Basel Committee and the International Organization of Securities Commissions (IOSCO) in 2005 to update the Market Risk Amendment (MRA), developed a decade ago by the Basel Committee. These amendments would apply to any banking organization that has significant trading book activity, whether it stays on Basel I or moves to Basel II in the United

States. The market risk NPR is intended to improve the risk sensitivity of the market risk capital framework. Further, it will serve to level the playing field between U.S. banking organizations and securities firms that are subject to similar capital requirements.

Moving to the main focus of today's hearing, the Basel II framework represents an important effort by supervisors to integrate modern risk-management practices with regulatory capital requirements. We are pleased that the four federal banking agencies have reached consensus to move ahead with the process for Basel II and the market risk update. We recognize the significance of this development to the industry, the Congress, and others who have waited for greater specificity about U.S. efforts to implement Basel II. It has taken quite a bit of work to reach this point. I would like to thank my colleagues here at this table and their staffs, as well as the Fed's own staff, for their tireless efforts.

Overview of Proposed Rulemakings

The Basel II NPR is designed to improve the risk sensitivity of U.S. bank regulatory capital requirements and to enhance the risk-measurement and -management practices of large, internationally active U.S. banking organizations. The NPR is based on the 2004 capital adequacy framework released by the Basel Committee on Banking Supervision. That framework contains the now-familiar "three pillars" of minimum capital requirements for credit and operational risk (Pillar 1), supervisory review (Pillar 2) and public disclosure (Pillar 3). As you are aware, the agencies propose to adopt all three pillars in the United States. In Pillar 1 as proposed by the Basel II NPR, only the most advanced internal ratings-based approach (A-IRB) for credit risk and the advanced measurement approaches (AMA) for operational risk would be available, and the framework as a whole would be required only for the largest, most complex, internationally active U.S. institutions. In contrast, in many other countries *all* banking

organizations are required to adopt Basel II because Basel I will be dropped when Basel II takes effect. To make Basel II appropriate for the wide variety of financial institutions, three credit risk and three operational risk approaches were developed in the 2004 framework.

The A-IRB approach for credit risk in the Basel II NPR requires institutions to estimate key risk parameters for each type of credit exposure, subject to supervisory review, and to calculate a capital requirement by using those risk parameters as inputs. The AMA approach for operational risk requires institutions to calculate a capital requirement based on their individual operational risk profile--again, subject to supervisory review. The Basel II NPR also specifies, as part of Pillar 2, that each institution must develop a rigorous internal process for assessing its overall or total capital adequacy in relation to its risk profile for other types of risk and through economic cycles. These internal assessments will enable each institution to determine the appropriate level of capital for its unique long-term business strategy. These internal capital assessments are, we believe, critically important, and are also subject to supervisory review. Finally, institutions must publicly disclose key information relating to credit and operational risks, under Pillar 3, to ensure adequate transparency for market participants, customers, and counterparties, so that market discipline can also work effectively to differentiate risk exposures among banking organizations. I would like to stress that the Basel II framework has three Pillars and note that Pillars 2 and 3 are critical components of the overall framework. They should not be overlooked.

To accompany the Basel II and market risk proposals, the agencies plan to publish in the *Federal Register* reporting requirements for institutions planning to adopt Basel II and the updated market risk rules in the United States. Each institution that qualifies for and applies the Basel II capital rules and the updated market risk rules would file quarterly regulatory data, some

of which would remain confidential, for the agencies' use in assessing and monitoring the levels and components of each reporting entity's risk-based capital requirements and the adequacy of the entity's capital. These data also would support the agencies' efforts to analyze the quantitative impact and competitive implications of the Basel II capital rules and the updated market risk rules on individual reporting entities and on an industrywide basis. In addition, the reporting schedules will help clarify for these entities our expectations surrounding the systems and other infrastructure necessary for implementation and validation of the two proposals. The submitted data would supplement on-site examination processes, and the data released publicly would provide other interested parties with information about banks' risk profiles and capital adequacy.

Importance of the Regulatory Capital Proposals

While our reasons for moving to Basel II have not changed since we began this endeavor, I believe they are worth reiterating. Our core reason is that the current Basel I framework is inadequate for the largest, most complex U.S. banking organizations. The current Basel I capital requirements simply are not able to capture the full array of risks facing these organizations. For example, they do not explicitly recognize the operational risk embedded in many of the services from which the largest institutions generate a good portion of their revenues today.

Further, Basel I does not differentiate the riskiness of assets within the major asset types based on either borrower creditworthiness or the presence of collateral or other risk mitigants. This lack of sophistication can lead to significant distortions and capital arbitrage. The capital required for the various types of exposures should reflect the unique business strategy of each institution, rather than be based on an assumed homogeneous risk position. As banks consciously choose to take higher risk exposures, Basel II requires them to hold additional

capital to reflect their business choice. Basel I capital is fixed throughout economic and business credit cycles, and as such, does not require banks to increase capital as their potential for losses rises. Basel II addresses this by including in Pillar 2 the requirement that the bank have a plan in place to ensure that sufficient capital will be available in the downturn of the economic cycle. Thus, for the largest organizations, we need to move beyond Basel I to a more risk-sensitive and more comprehensive framework for assessing capital adequacy. Basel II represents the concerted efforts of the international and U.S. supervisory community, in consultation with banks and other stakeholders, to develop such a framework, drawing upon well-known economic capital concepts that the largest banks already employ as part of their risk management efforts.

In addition to its supervisory authority, the Federal Reserve, as the nation's central bank, has responsibility for maintaining stable financial markets and ensuring a strong financial system. That responsibility mandates that we require banking organizations to operate in a safe and sound manner with adequate capital that appropriately supports the risks they take. This is especially critical in today's environment where we have a growing number of banking institutions with more than $1 trillion in assets, complex balance sheets, opaque off-balance sheet transactions, and far-reaching operations that pose significant risk-management challenges that are fundamentally different from those faced by smaller institutions. Naturally, we must also ensure that our regulations and supervisory oversight are in tune with bank practice, are able to identify the risks being taken by banks today, and have enough flexibility that they will continue to be prudent and relevant in an ever-changing risk environment. As Chairman Bernanke has noted, a regulatory and supervisory system that is not in tune with the financial marketplace may increase the costs of regulation, stifle efficiency and innovation, and ultimately be less effective in mitigating the moral hazard problems associated with the federal safety net.

The advanced approaches of Basel II are much more risk sensitive, cover more areas of potential risk facing banking organizations, and provide incentives for these institutions to improve risk measurement and management. In addition, Basel II provides supervisors with a more conceptually consistent and more transparent framework for evaluating systemic risk in the banking system, particularly through credit cycles. In sum, Basel II will establish a more coherent relationship between regulatory measures of capital adequacy and day-to-day supervision of banks, enabling examiners to better evaluate whether banks are holding prudent levels of capital given their risk profiles.

Continuing the Implementation Process

The agencies' proposed rulemakings, representing our view about how Basel II should be implemented in the United States, are being published in the *Federal Register* for review by the industry, the Congress, and the general public. The core goal of Basel II, as noted earlier, is to promote the stability of the U.S. financial system by ensuring the safety and soundness of U.S. banks. As Chairman Bernanke has said, the ability of Basel II to promote safety and soundness is the first criterion on which the proposed Basel II framework should be judged. The agencies have presented proposals and will now engage in a continuing dialogue with all interested parties as to whether those proposals meet our stated objectives and can be improved.

During the entire process to develop our proposed rulemakings, the agencies have been engaged in a dialogue with the industry, the Congress, and others about both the direction that U.S. Basel II implementation should take and specific implementation details. Many of the comments received to date have been incorporated into our proposals. In that respect, we have been carefully considering comments received so far and discussing among ourselves how to address them. In addition, we have conducted extensive analysis of other information we have

been collecting, such as the results of quantitative impact studies (QIS), and those results have helped shape the proposals as well. In making adjustments to our proposals based on comments and new information, we have been as transparent as possible. Going forward, we will seriously consider all comments on the proposals. For example, the proposals contain a number of specific questions soliciting comments in key areas. With these questions, the agencies are trying to highlight areas on which the agencies would like additional information. The agencies will continue to carefully consider all comments received and thoroughly analyze all relevant information as we work to develop a final rule for Basel II.

I also want to acknowledge that the agencies have received comments from several banks and other parties suggesting that banks should have more choices with regard to both credit and operational risk in Basel II in the United States. We have taken these comments seriously and the NPR now includes a specific question on whether the U.S. version of Basel II should include a so-called "standardized" approach to credit risk. We look forward to receiving detailed comments on this and all aspects of the proposals.

The agencies' proposals contain certain transitional safeguards beyond what is contained in the 2004 framework. Indeed, these proposed safeguards reflect our intent to ensure that there are no material weaknesses in our proposals prior to full operation. First, we continue to monitor institutions' progress toward satisfaction of the Basel II risk-measurement and -management infrastructure standards. In addition, our proposals contain a parallel-run period in which we will have the ability to analyze and directly compare capital requirements under existing rules and those produced by Basel II while institutions remain subject to the current rules. Beyond the parallel run, the agencies have proposed a three-year transitional floor period, more stringent than that in the 2004 Basel II framework, to prevent an unwarranted decline in capital levels. In

addition, current supervisory safeguards, such as the existing leverage ratio and prompt corrective action, will continue to provide an important backstop against a potential unwarranted decline in bank capital levels. In general, if we at the Federal Reserve see that the U.S. Basel II proposals are not working as intended, we will seek modifications to them.

Proposals to Amend Existing Basel I Rules

At this point, I would like to say just a few words about ongoing efforts to revise the existing Basel I regulatory capital rules for non-Basel II institutions. We expect only one or two dozen institutions to move to the U.S. version of Basel II in the near term, meaning that the vast majority of U.S. institutions will continue to operate under Basel I-based rules, which we intend to amend through a separate rulemaking process. The U.S. Basel I framework has already been amended more than twenty-five times since its introduction in response to changes in banking products and the banking environment and as a result of a better understanding of the risks of individual products and services. The agencies believe that now is another appropriate time to propose modifications to our Basel I rules. The agencies have issued an advance notice of proposed rulemaking (ANPR) discussing possible changes to increase the risk sensitivity of the U.S. Basel I rules and to mitigate competitive distortions that might be created by introducing Basel II. We are now reviewing comments on the ANPR and working on a notice of proposed rulemaking. We are mindful that amendments to the Basel I rules should not be too complex or too burdensome for the large number of small- and mid-sized institutions to which the revised rules might apply. Indeed, a number of those commenting on the ANPR advocated leaving existing rules unchanged.

With regard to both the Basel II proposals and the proposed Basel I amendments, we understand the need for full transparency. For that reason, we expect to have overlapping

comment periods for the Basel II NPR and the NPR for the proposed Basel I amendments. In fact, we want all interested parties to compare, contrast, and comment on the two proposals in overlapping timeframes. Accordingly, either of our proposals could change as a result of comments received or new information gathered.

Conclusion

From the Federal Reserve's perspective, the forthcoming publication of interagency proposals relating to Basel II is a very positive development and demonstrates the ability of the agencies to work cooperatively to modernize our regulatory capital framework. The Federal Reserve's commitment to the Basel II process remains as strong as ever, even as we recognize that the proposals remain subject to further comment and that there is likely much more work to be done. We encourage comments from all interested parties and will give them careful consideration. I would like to emphasize the Federal Reserve desires to ensure that the final rule for Basel II is a substantial enhancement over existing Basel I rules, appropriately capturing the risks of our largest, most complex banks, and encouraging continual improvement in risk-measurement and -management systems. We look forward to working with the other agencies as we enter into the final rule phase of the Basel II process.

We recognize that many institutions have been diligently preparing for Basel II implementation and we understand our obligation, as supervisors, to support institutions wanting to adopt Basel II at the first available date. We suggest that those institutions continue to move forward with implementation planning, including identification of gaps in their own preparation.

Finally, I would like to assure the Subcommittee members that we at the Federal Reserve are pursuing Basel II because we believe it will help to preserve the safety and soundness of our nation's banking system. In our dual role as central bank and supervisor of banks, bank holding

companies, and financial holding companies, the Federal Reserve is committed to ensuring that the Basel II framework delivers a strong and risk-sensitive base of capital for our largest and most complex banking institutions. That is why we stand behind the additional safeguards contained in the Basel II NPR to ensure strong capital levels during the transition to the new framework. We will remain vigilant, on an ongoing basis, in monitoring and assessing the impact of Basel II on both individual and aggregate minimum regulatory capital requirements and in employing rigorous and thorough analysis to support our evaluation. By so doing, we believe that the proposals being discussed today can be implemented responsibly and in a safe and sound manner.

Proposed Interagency Guidance on Commercial Real Estate Concentration Risk

The four federal bank and thrift regulatory agencies issued joint proposed guidance in January 2006 on the sound risk management of commercial real estate concentrations. The comment period closed in April. The proposed guidance generated significant interest. The Federal Reserve received more than 1,600 comment letters on the proposed guidance. Typically, the comments raised concerns about the intent and purpose of the proposed guidance. Over the past few months, the Federal Reserve and the other federal banking agencies have been reviewing these comments carefully and have met with industry trade groups and individual bankers.

In my testimony today, I would like to provide some perspective on why the agencies are concerned about CRE concentrations and the risks they may pose, and why we saw the need to issue the proposed guidance. I will also address the intent of the proposed guidance and some misconceptions that have arisen.

First, I would like to explain how we define commercial real estate. For purposes of this guidance, CRE loans include land development and construction loans (both commercial and 1-to-4 family residential construction) and loans secured by raw land, multi-family property, or nonfarm nonresidential property where the primary or a significant source of repayment is derived from rental income associated with the property or the proceeds of the sale, refinancing, or permanent financing of the property. The proposed guidance does not apply to owner-occupied CRE loans where the majority of repayment comes from income from the borrower's business operations.

Over the past dozen years, the agencies have observed a material rise in CRE concentrations at many banks. For small- to medium-sized banks, in particular, the growth in CRE concentrations has been significant. This growth in CRE concentrations is understandable as community-based banks have experienced increasing competitive pressure from larger banks and other financial services institutions in other lending areas.

We recognize that asset concentrations can, on a practical basis, be difficult to avoid due to an institution's marketplace, area of expertise, or competitive environment. However, as experience has amply demonstrated, large and growing asset concentrations such as we are seeing today in some banks can adversely affect banks' earnings and capital, and indeed banks' safety and soundness, if not properly managed. For that reason, prudent banks have long understood the importance of managing credit concentration risks--it is one of the basic tenets of banking that the Federal Reserve has long emphasized.

So what exactly are concentrations of credit and what risks do they pose to institutions? Concentrations of credit are generally defined as groups or classes of loans or other credit exposures that share common risk characteristics or sensitivity to adverse economic, financial or

business developments. For a given concentration, when weaknesses develop in a common risk factor or factors, loans within that concentration may be adversely affected, even if every individual loan has been underwritten prudently. As bank supervisors, we have seen the dangers of credit concentrations in previous CRE credit cycles.

Let me provide you with some details on the trend we have observed. CRE concentrations have almost doubled between 1992 and 2005 for all commercial and savings banks with assets between $100 million and $10 billion. During this period, for those banks with assets between $100 million and $1 billion, CRE concentrations rose from 160 percent to 294 percent of capital, while for those with assets between $1 billion and $10 billion, CRE concentrations rose from 143 percent to 266 percent of capital.

Why are the agencies focusing on CRE concentration risk? The agencies are concerned that the high CRE concentrations would make institutions more vulnerable to adverse changes in CRE markets. CRE markets tend to be among the most cyclical, prone to boom and bust economic cycles. This is because a poorly underwritten project or overbuilding in a market can have significant negative effects on CRE loans that are soundly underwritten. To increase occupancy rates, weaker projects may lower rents and provide more generous terms to attract tenants. This in turn can reduce cash flow to stronger properties and put those credits at risk.

As you know, in the late 1980s and early 1990s, concentrations in CRE lending, coupled with weak underwriting and depressed CRE markets, contributed to large credit losses at some banks, significant numbers of bank failures, and financial stress at many other banks. After recovering from the severe credit losses of that CRE downturn, most U.S. CRE markets have enjoyed very benign conditions. But investment in CRE is again growing strongly, and we

expect banks to assess the vulnerabilities of their portfolios to loss in expectation of the next downturn.

Compounding our concern about rising CRE concentrations is feedback from our examiners that some institutions' risk-management practices have not kept pace with the growth in their CRE concentrations. Supervisory staff have found weaknesses in fundamental risk-management areas such as board and management oversight, risk assessment, and monitoring. In addition, examiners have observed that institutions have not always sufficiently addressed CRE concentration risk in their strategic and capital planning.

We are also carefully monitoring underwriting standards. While the U.S. CRE market is generally performing well, underwriting terms and conditions have been softening over the past couple of years, albeit not to the extent seen in the late 1980s and early 1990s. Loosening loan covenants, expanding interest-only periods, and extending amortizations are some examples of the weakening underwriting terms that we are currently observing. Capitalization rates of CRE projects--which measure the expected investor return on real estate investments--are also near historical lows, which raises concerns about collateral values and loan-to-value ratios in the event capitalization rates should return to historical mean levels.

Many bankers have argued that the agencies already have the supervisory tools available to address concerns about concentrations at individual banks and that the guidance would add unnecessary regulatory burden. Our current real estate lending guidelines were issued in 1993 under the Federal Deposit Insurance Corporation Improvement Act. The issuance of guidance to banks and examiners is one of our most important supervisory tools for focusing attention on emerging risk issues before they become larger problems and for articulating supervisory expectations to our institutions. Given the rising concentration levels, and the current stage of

this CRE cycle, we believe that there is now a need for additional CRE guidance to reinforce and build upon our existing guidance and to ensure a consistent supervisory approach.

It is important to stress that the intent of the proposed guidance is not to restrict CRE lending but rather to provide a framework for a safe and sound CRE lending program. The agencies recognize that financial institutions play a vital role in providing credit to their communities. The main message in the proposed guidance is that banking institutions need to identify and manage credit-concentration risks appropriately.

Under the proposed guidance, we would expect banks to strengthen their management practices as their concentration risks grow. The proposed guidance sets forth risk management practices that are well within the capabilities of many institutions and, in fact, a number of institutions already have many of these practices in place.

Not surprisingly, the establishment of explicit thresholds in the proposal has generated significant controversy. Bankers have argued that the thresholds are arbitrary and will be viewed as hard lending limits by examiners and the industry. I want to re-emphasize that the agencies' intent in proposing these thresholds was not to limit an institution's CRE lending but to ensure that risk-management practices are commensurate with this activity. Rather, the thresholds should be viewed as supervisory screens that examiners should use to identify banks with potential CRE concentration risk. Examiners would expect organizations to strengthen their portfolio risk management as CRE concentrations grow. Institutions are expected to conduct their own analyses of CRE concentration risk and establish their own concentration limits. Institutions, after all, are in the best position to identify and understand their concentration risk.

Another significant concern expressed in the comment letters by bankers is that the proposed guidance will be implemented in an inconsistent manner, creating an uneven playing

field with some banks facing higher supervisory expectations. Issuing the guidance on an interagency basis should encourage a consistent supervisory approach. Further, the agencies are also developing interagency training materials about the new guidance for their examiners to support more effective and consistent implementation.

Another concern expressed by bankers is that examiners will take a "one-size-fits-all" supervisory approach and will not consider a bank's specific portfolio characteristics and risk-management practices when applying the guidance. The supervisory evaluation of institutions' CRE concentration risk would always be conducted on a case-by-case basis, taking into consideration the institution's own analysis of its CRE concentration risk. The diversity of an institution's CRE portfolio, the effectiveness of an institution's risk-management practices, and the presence of any other factors that mitigate its risks would be key considerations in the supervisory evaluation of the level of an institution's CRE concentration risk.

Bankers in their comments also have expressed concern about how examiners will evaluate capital adequacy for banks with a CRE concentration. The proposed guidance addresses capital adequacy in a principles-based manner, noting that institutions should hold capital commensurate with the level and nature of all their risk, including their concentration risk. This message is entirely consistent with the agencies' existing capital adequacy guidelines. In evaluating capital adequacy, the agencies will consider, for example, the level and nature of inherent risk in an institution's CRE portfolio as well as management expertise, historical performance, underwriting standards, risk-management practices, market conditions, and any loan loss reserves allocated for CRE concentration risk. Moreover, the quality of institutions' risk-management practices will be a significant consideration in the evaluation of capital adequacy. Our concerns about capital adequacy will be reduced if an institution has strong risk-

management practices. On the other hand, if an institution has inadequate risk management and no prospects for near-term improvement, there could be a concern that the institution may not have sufficient capital to serve as a buffer against unexpected losses from CRE concentrations.

Finally, bankers' comments have expressed concerns about how the issuance of the proposed guidance might affect the availability of CRE credit. The proposed CRE concentration guidance is not intended to limit or discourage institutions' CRE lending. We recognize that such lending is an important business activity for banks. We also believe that CRE concentration risk can be safely managed. In that regard, the proposed guidance is simply intended to reinforce and build upon existing guidance on risk-management practices for addressing the risks arising from concentrations in CRE lending.

In conclusion, although it is sometimes an unpopular strategy when loan performance is good, we believe that it is far more prudent, and indeed our responsibility, to work proactively to address small but emerging issues to help prevent their evolution into larger problems for the banking industry and the economy as a whole. That is why we feel it is important to issue this guidance at this time.

Thank you very much for your attention. I welcome any comments you may have and will be happy to answer any questions.

Testimony of Robert L.D. Colby
Acting Director, Division of Market Regulation
U.S. Securities and Exchange Commission

"Prudential Supervision of U.S. Securities Firms"

Before the Subcommittee on Financial Institutions and Consumer Credit
U.S. House of Representatives

September 14, 2006

Chairman Bachus, Ranking Member Sanders, and Members of the Subcommittee:

As the Acting Director of the Division of Market Regulation of the Securities and Exchange Commission, I am very pleased to have the opportunity this morning to describe the Commission's program for monitoring capital at U.S. securities firms.

Generally, each broker-dealer registered with the Commission must comply with the Commission's net capital rule, Rule 15c3-1 under the Securities Exchange Act of 1934. The net capital rule is intended to be a conservative capital standard that requires broker-dealers to maintain liquid assets in excess of their liabilities. Illiquid assets, such as most unsecured receivables, are deducted in full when calculating a broker-dealer's net capital. Further, when calculating net capital, a broker-dealer is required to take additional deductions, known as haircuts, with regard to its proprietary securities positions. The net capital rule is designed to require that a broker-dealer have sufficient liquid assets to meet all of its obligations to customers and other market participants in an insolvency, without the need for a formal liquidation proceeding or the use of the Securities Investor Protection Corporation's fund.

Although the net capital rule has been an effective capital measure for registered broker-dealers, as securities business expanded and broker-dealers became part of international financial conglomerates, the Commission became increasingly concerned about the risk that a broker-dealer may fail due to the insolvency of its holding company or affiliates. This risk was exemplified by the bankruptcy of the Drexel Burnham Lambert Group in 1990 and the consequent liquidation of its broker-dealer affiliate. Post-Drexel, the Commission took a number of initiatives to conduct group-wide risk assessments of financial institutions that have significant broker-dealer subsidiaries. The initiatives included (1) Commission implementation of the Market Reform Act of 1990 to require that larger broker-dealers report certain risk assessment information to the Commission about their material affiliates, (2) encouraging the creation of the Derivatives Policy Group consisting of securities firms active in over-the-counter derivatives that agreed to voluntarily provide information to the Commission about their unregulated over-the-counter derivatives activities, and (3) the Commission's program for supervision of over-the-counter derivatives dealers that register as limited broker-dealers. These initiatives

assisted the Commission in understanding how investment banks with large broker-dealer subsidiaries manage risk globally at the group-wide level.

Building upon those initiatives, in 2004 the Commission amended its net capital rule to establish a voluntary, alternative method of computing net capital for well capitalized broker-dealers that have adopted strong risk management practices. This alternative method permits a broker-dealer to use mathematical models to calculate net capital requirements for market and derivatives-related credit risk. As a condition to that exemption, the broker-dealer's ultimate holding company must consent to group-wide Commission supervision, thus becoming consolidated supervised entities, or CSEs. Formally supervising the financial condition of the broker-dealer holding company and its affiliates on a consolidated basis allows the Commission to monitor better, and act more quickly in response to, any risks that affiliates and the ultimate holding company will pose to regulated entities within the group or the broader financial system.

The Commission's program to supervise the CSEs also responded to concerns of the U.S. investment banks regarding the application of the European Union's Financial Conglomerates Directive to their activities in Europe. The Directive requires that firms active in Europe be supervised at the group level under a regulatory approach equivalent to those applied in the European Union, or face significant restrictions on their activities. The European Union recognized that there is broad equivalence in the Commission supervisory approach with respect to the CSE oversight program.

Currently, five U.S. investment bank holding companies, The Bear Stearns Companies Inc.; Goldman Sachs Group, Inc.; Lehman Brothers Holdings Inc.; Merrill Lynch & Co., Inc.; and Morgan Stanley, are supervised as CSEs. In addition, Citigroup Global Markets Inc., a broker-dealer subsidiary of Citigroup Inc., has received an exemption to use the alternative method to compute its net capital. A broker-dealer whose holding company already has a principal regulator, such as Citigroup, can apply for the alternative method for computing net capital, and the CSE rules rely on supervision by that principal regulator as a basis for substantially less direct Commission supervision of the holding company than one that does not have a principal regulator.

Under the Commission's CSE program, the ultimate holding company must provide the Commission with information at the group level covering its global businesses, whether or not these activities are conducted in functionally regulated entities such as banks or broker-dealers. Those affiliates that do not have a principal financial regulator, as well as the holding company itself, are subject to examination by the Commission. The CSE rule also requires monthly calculation at the holding company level of a capital adequacy measure that is designed to be consistent with the standards adopted by the Basel Committee on Banking Supervision. This should allow for greater comparability of a CSE firm's financial position to other international securities firms and banking institutions.

In requiring a holding company calculation of capital in accordance with the Basel standard, the CSE rules do not specify that capital adequacy be calculated using the

original framework, Basel I, or the revised framework, Basel II. Likewise, the rule does not prescribe the use of the "advanced" approaches contained in Basel II that make extensive use of internal models in the computation of credit risk capital charges. Nonetheless, four of the five CSE firms elected to satisfy the CSE capital calculation requirement by applying Basel II and its advanced approach to credit risk exposure, and the Commission agreed to that approach. These firms were concerned that if they used the standardized approach for calculating credit risk capital requirements, they would be viewed as being less sophisticated than other internationally active institutions. The fifth firm, who because of its fiscal year was confronted with a period of only six months between publication of Basel II by the Basel Committee and the effective deadline imposed under the EU Financial Conglomerates Directive, opted to apply Basel I. This firm is now in the process of preparing to implement Basel II.

When the CSE firms began in earnest to implement Basel II during the latter part of 2004, the only complete description of the standard was the "midyear text," published by the Basel Committee in June 2004. Thus this text served as the basis for implementation of Basel II by the CSE firms.

This is not to say that the implementation of Basel II by the CSE firms has been simple. Commission staff has worked collaboratively with our banking colleagues to address issues that are central to the CSE firms. The staff believes that the CSE firms have implemented Basel II in a manner that is conservative while also reflective of the fundamental nature of securities firms and their business model.

Looking ahead, when the US banking regulators formally issue the draft Notice of Proposed Rulemaking regarding the implementation of Basel II, Commission staff will review the document carefully to apply the proposed approaches to securities firms in the context of their history, risk profile, and business mix. Areas that will be reviewed during this process undoubtedly will include the treatment of private equity positions, the allowed methodology for computing the exposure at default for over-the-counter derivatives and similar transactions, and conditions for the recognition of collateral for capital purposes. Where further modifications to the calculation methodologies used by CSE firms are warranted, the Commission has authority to require their adoption. The CSE firms understood, when they elected to apply the Basel II standard during 2005, that the standard was still very much a work in progress, and that they were likely to have to make various adjustments as the broader US implementation process moved forward.

One final note: in addition to the Basel capital calculation required of CSE firms, the Commission also requires CSE firms to meet certain liquidity risk standards. Securities firms rely on a wide range of funding sources, notably repurchase and repurchase-like secured financing of assets. In the face of any crisis – whether real or only perceived – secured lenders are likely to require significantly more collateral, while unsecured lenders may disappear altogether. Because the CSE firms do not have a lender of last resort, they must conscientiously manage this liquidity risk through their own resources. There are a number of instances where securities firms that were adequately capitalized by the measures of the day collapsed because the asset side of the balance sheet proved

insufficiently liquid to withstand a stress event. Thus, under the CSE program, the Commission looks not just at capital adequacy, but also at the liquidity of the assets being supported by that capital through an additional set of standards. Generally, each CSE firm must have sufficient stand-alone liquidity and sufficient financial resources to meet its expected cash outflows in a stressed liquidity environment for a period of at least one year. To meet these standards, each CSE firm holds a substantial amount of liquid assets that are available to the ultimate holding company and its subsidiaries to deal with a crisis or perceived crises anywhere within the organization.

In summary, we are confident that the CSE firms are currently calculating a capital adequacy measure consistent with Basel II in a manner appropriately sensitive to the risks assumed by the firms. To the extent that further modifications of the calculations become necessary in order to continue to achieve this primary goal, while maintaining to the maximum extent possible consistency with national and international regulatory authorities, the Commission has both the commitment and the regulatory authority under the CSE rules to ensure that the appropriate changes are made.

Thank you again for inviting me to appear before you today and I am happy to answer any questions you may have.

For Release Upon Delivery
10:00 a.m., September 14, 2006

TESTIMONY OF

JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

September 14, 2006

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

INTRODUCTION

Chairman Bachus, Ranking Member Sanders, and members of the Subcommittee, I appreciate this opportunity to discuss two important initiatives of the U.S. banking agencies – our proposals to update and enhance our regulatory capital program and our proposed commercial real estate guidance.

Though different in scope and structure, these two interagency efforts share a fundamental goal – to ensure that bank risk management practices and regulatory capital requirements are commensurate with the current and emerging risks facing the banking industry. I view this goal as one of my highest supervisory priorities and critical to the maintenance of the long-term safety and soundness of our banking system. While the U.S. banking industry continues to operate profitably, supervisors must ensure that bank risk management systems and regulatory capital rules appropriately address current and emerging safety and soundness challenges.

The agencies have and will continue to foster an open process as we move forward with these proposals to consider comments from all interested persons, heed good suggestions, and address legitimate concerns. In this way, we can ensure that we make prudent, well reasoned, and well understood changes to bank capital requirements and supervisory policies.

RISK-BASED CAPITAL

Let me begin with the risk-based capital proposals. The agencies have developed two distinct proposals to better tailor a bank's capital rules to the complexity of its risks. For our largest banks, the fundamental thrust of our efforts is the U.S. implementation of the Basel II Framework – a more risk-sensitive regulatory capital system better suited to

the complex operations and activities of these institutions. For banks not adopting Basel II, the primary goal of our so-called Basel IA initiative is to increase the risk sensitivity of our risk-based capital rules without unduly increasing regulatory burden.

Basel II

The 1988 Basel Accord, also referred to as Basel I, established a framework for risk-based capital adequacy standards that has now been adopted by most banking authorities around the world. The U.S. agencies have applied rules based on the 1988 Basel Accord to all U.S. insured depository institutions. Although Basel I was instrumental in raising capital levels across the industry in the United States and worldwide, it became increasingly evident through the 1990s that there were growing weaknesses in Basel I. In particular, the relatively simple framework has become increasingly incompatible with the increased scope and complexity of the banking activities of our largest banking institutions. The crude risk-weighting mechanisms of Basel I bear little resemblance to the complex risk profiles and risk management strategies that larger banks are capable of pursuing. The misspecification of risk under Basel I creates inappropriate incentives and arbitrage opportunities that can undermine supervisory objectives. And dealing with outdated and mismatched regulatory requirements is costly to banks.

In response to these issues, the Basel Committee commenced an effort to move toward a more risk-sensitive capital regime, culminating in the publication of the Basel II Framework. As the OCC has noted in earlier hearings, we firmly support the objectives of the Basel Committee and believe that the advanced approaches of the Basel II

Framework – the advanced internal ratings-based approach (IRB) for credit risk and the advanced measurement approaches (AMA) for operational risk – constitute a sound conceptual basis for the development of a new regulatory capital regime for large internationally active banks.

Last week, the agencies completed the internal approval processes necessary to publish in the *Federal Register* a notice of proposed rulemaking (NPR) regarding the implementation of Basel II in the United States. The Basel II NPR, a draft of which is already publicly available, has been sent to the *Federal Register,* and we expect it to be published to begin the official 120-day public comment period within a few days.

Last week's actions reflected a consensus by all U.S. agencies that implementation of the Basel II Framework should move forward to the next stage in the process. In that context, the agencies agree on two fundamental points: first, supervisors must ensure that regulatory capital rules appropriately address existing and emerging risks, and second, the current, simplistic Basel I framework no longer does that for our more complex banks.

Indeed, the inadequacies of the current framework are especially pronounced with respect to larger U.S. banks, which we know well, because the OCC is the primary federal supervisor for the five largest. These institutions, some of which hold more than $1 trillion in assets, have complex balance sheets, take complex risks, and have complex risk management needs that are fundamentally different from those faced by community and mid-sized banks. For that reason, the agencies developed the Basel II NPR, which is itself complex, but which would be required to apply to only a dozen of our largest and most internationally active U.S. banks.

The purpose of Basel II implementation in the United States is not only to align capital requirements much more closely to the complex risks inherent in these largest institutions, which the proposal attempts to do. At least as important – and this is a total departure from the existing capital framework – the proposal would also require our largest banks to substantially improve their risk management systems, control structures, risk information systems, and related public disclosures. These enhancements would be accomplished using a common framework and a common language across banks that would allow regulators to better quantify aggregate risk exposures, make more informed supervisory decisions, and make peer comparisons in ways that we cannot today. If successful, such improvements would establish a more rigorous relationship among risk, risk management, and capital in our supervisory structure and measurably strengthen our safety and soundness regime for our largest banks. In addition, the enhanced public disclosure required under Basel II would better inform the market about a bank's risk exposures and provide a consistent and understandable disclosure framework that would enhance comparability and facilitate market discipline.

As has been widely reported, we have received several comments on a draft version of this NPR that was released earlier this year. Certain of those commenters requested that we amend the NPR to permit Basel II banks the option of using simpler approaches in the calculation of capital requirements for credit risk and operational risk. To ensure that all interested parties have the opportunity to comment on this fundamentally important issue, the agencies added a question to the Basel II NPR's preamble addressing this issue. As I mentioned earlier, one of the primary goals of the agencies in developing these proposals is – as much as possible – to tailor a bank's

capital rules to the complexity of its risks. Thus, the advanced approaches of the Basel II NPR are targeted to large, complex banks. By the same token, the simpler Basel II approaches, as well as the forthcoming Basel IA proposal, have been developed with an eye towards less complex banks with more traditional risk profiles and activities. In this regard, we are very interested in comments on the appropriateness of permitting simpler alternatives to the advanced approaches for our largest, most complex banks, especially as it relates to safety and soundness and competitive equity concerns. I believe this is a legitimate question, given that the largest banks in other Basel II countries have the option of simpler alternatives to the advanced approaches. On the other hand, as the agencies note in the preamble to the NPR, virtually all non-US banks comparable in size and complexity to our core banks appear to be adopting the advanced approaches, though not with the changes that we propose in the NPR. I hope commenters will take all these factors into account when responding to the question.

The agencies have also received comments from U.S. banks expressing concerns about what they believe is the excessive conservatism of the NPR. Many of the specific provisions of the NPR cited by the banks relate to safeguards put in place by the agencies after an assessment of the results of our last quantitative impact study, discussed below, including the enhancement of the NPR's transition period to strictly limit potential reductions in capital requirements through capital floors and other devices.

In previous Congressional testimony, in Basel Committee deliberations, and in discussions with the industry and other supervisors, the OCC has repeatedly emphasized that reforms to our regulatory and supervisory structure must be adopted in a prudent, reflective manner, consistent with safety and soundness and the continued competitive

strength of the U.S. banking system. In furtherance of those standards, the U.S. agencies conducted Quantitative Impact Study 4 (QIS-4) in late 2004 and early 2005.

It is well known that QIS-4 helped us identify significant issues about Basel II implementation that have not been fully resolved. The QIS-4 submissions evidenced both a material reduction in the aggregate minimum required capital for the QIS-4 participant population and a significant dispersion of results across institutions and portfolio types. One measure produced by QIS-4 is the estimated change in "effective minimum required capital," which represents the change in capital components, excluding reserves, required to meet the eight percent minimum total risk-based ratio. This measure is independent of the level of capital actually held by institutions and of their currently measured capital ratios. After application of a scaling factor as proposed in the NPR, the decrease in effective minimum required capital compared to existing standards was 11.7 percent, with a median decrease of 22.6 percent, aggregating over the QIS-4 participants. Additional QIS-4 analyses also confirmed that the dispersion in results – with respect to individual parameter estimates, portfolios, and institutions – was much wider than we anticipated. In particular, the agencies' additional analysis revealed a wide dispersion of results between institutions with respect to individual credit exposures and selected portfolios, even when controlling for differences in risk.

In short, the QIS-4 results and the inevitable questions they raise have been the source of serious concern for the banking agencies. There is consensus among the agencies that, if these were indeed the results that would be produced by a final Basel II rule, that would be unacceptable. Having said that, there were very significant limitations to QIS-4, and as a result, it would be a mistake to assume that the magnitude of the

reduction and dispersion in capital requirements that were estimated would hold true with a fully implemented Basel II rule. In particular, because the regulators had not yet specified all the requirements for a complete Basel II regime, QIS-4 could not be designed to take into account such requirements. Even more important, the integrity of the final capital requirements produced by a "live" Basel II system will be affected fundamentally by the scrutiny that examiners will apply to the inputs that banks will provide to produce the final capital requirements. With a final rule, final supervisory guidance, and rigorous examiner scrutiny, we believe the magnitude of capital reductions and dispersion revealed by QIS 4 is likely to be mitigated.

Nevertheless, that outcome is not assured, and as a result, the process for implementing Basel II as established in the NPR is designed to provide the OCC and other agencies a complete understanding of the Framework's implications for the banking system without risking unacceptable capital reductions. Specifically, the Basel II NPR includes several key elements that allow for the progress we believe is necessary, over time, for risk management and supervisory purposes, while strictly limiting reductions in risk-based capital requirements that might otherwise result from systems that have not been proven.

The first element is a one-year delay in initial implementation, relative to the timeline specified by the Basel II Framework. As a result, the "parallel run," which is the pre-qualification period during which a bank operates IRB and AMA systems but does not derive its regulatory capital requirements from them, will be in 2008. The parallel run period, which will last at least four quarters but could be longer for individual institutions, will provide the basis for the OCC's initial qualification determination for

national banks to use Basel II for regulatory risk-based capital purposes. Following initial qualification, a minimum three-year transition period would apply during which reductions in each bank's risk-based capital would be limited. These limits would be implemented through floors on risk-based capital that will be simpler in design and more conservative in effect than those set forth in Basel II. For banks that plan to implement the Basel II Framework at the earliest allowable date in the United States, we are proposing the following timetable and transitional arrangements:

Year	Transitional Arrangements
2008	Parallel Run
2009	95% floor
2010	90% floor
2011	85% floor

The OCC will assess national banks' readiness to operate under Basel II-based capital rules consistent with the schedule above and will make decisions on a bank-by-bank basis about termination of the floors after 2011.

We will also retain the Prompt Corrective Action (PCA) and leverage capital requirements in the proposed domestic implementation of Basel II. For more than a decade those provisions have complemented our basic risk-based capital rules, and U.S institutions have thrived while building and maintaining strong capital levels – both risk-based and leverage. This capital cushion has proved effective, not only in absorbing losses, but also in allowing banks to take prudent risks to innovate and grow.

While we intend to be true to the timelines above, we also expect to make further revisions to U.S. Basel II-based rules if necessary during the transition period (*i.e.*, before the system-wide floors terminate in 2011) on the basis of observing and scrutinizing actual systems in operation during that period. That will allow us to evaluate the effectiveness of the Basel II-based rules on the basis of real implementation and to make appropriate changes or corrections while the prudential transition safeguards are still in effect. In other words, we will have strict safeguards in place to prevent unacceptable capital declines during the transition period, and if we believe that the rule would produce such declines in the absence of these safeguards, then we will have to fix the rule. Of course, any future revisions will also be subject to the full notice and comment process, and we expect to look to that process where necessary to help resolve difficult issues.

Having said all of this – especially the need for caution during the transition period – there may well be parts of the proposal that are overly conservative. The notice and comment process will undoubtedly result in a complete discussion by commenters of provisions that raise such concerns. I will carefully consider such comments, and to the extent they are valid, I believe we should make changes to the rule before it becomes final.

The OCC has been a frequent critic of many elements of the Basel II Framework, and we have worked hard to make important changes to the proposal that we thought made sense. But it is also true that, at critical points in the process, the OCC has supported moving forward towards implementation. Our reason for doing so is simple – an appropriate Basel II regime assists both banks and supervisors in addressing the increasingly complex risks faced by our largest institutions. While we may not have all

the details of the proposals right yet, and we will surely make changes as a result of the public comment process, I fully support the objectives of the Basel II NPR. I want to see these proposals work because I am convinced that, if they do, they will strengthen the safety and soundness of the banking system.

Basel IA

The complex Basel II NPR is neither necessary nor appropriate for the vast majority of U.S. banks. Many of these institutions need meaningful but simpler improvements in their risk-based capital rules to more closely align capital with risk. The OCC's primary objective in developing the Basel IA proposals is to create a domestic risk-based capital rule with greater risk sensitivity, but without unduly increasing complexity or burden. That is no small challenge, and we recognize that there will be limits in the level of risk sensitivity that we can achieve in a relatively noncomplex rule designed for broad applicability to a vast array of credit exposures.

Nonetheless, we believe there are areas in which our current rules can be significantly improved without requiring massive investments in new systems and controls. In that respect, it is important to note that, unlike Basel II, the Basel IA proposals are not intended, in and of themselves, to dramatically improve risk management. Rather, they represent an effort to design a simple but better measure of minimum regulatory capital requirements. Likewise, the results of Basel IA are not intended to replicate Basel II results – but by moving risk measurements in the right direction, we do expect to narrow some of the potential gaps between Basel IA and Basel II results.

The agencies remain committed to issuing the Basel IA NPR in the near future. We believe that overlapping comment periods for these two rulemakings is a critical element of our on-going effort to assess the potential competitive effects of both sets of proposals on the U.S. banking industry.

PROPOSED COMMERCIAL REAL ESTATE GUIDANCE

The agencies proposed guidance on January 13, 2006 to address sound risk management practices for banks with concentrations in commercial real estate (CRE) loans. The guidance focuses on concentrations in CRE loans that are particularly vulnerable to cyclical commercial real estate markets, those where the source of repayment primarily depends upon rental income from the property, or the sale, refinancing, or permanent financing of the property.

Last year, banks held about $1.3 trillion in CRE loans nationwide – a 16% increase in just one year. CRE lending is clearly an important and profitable line of business for many banks, so it is not entirely surprising that our proposed guidance has generated an outpouring of comment letters. We at the OCC have received more than 1,600. The concerns expressed in these comment letters have been amplified in many of my face-to-face discussions with bankers, especially mid-size and community bankers.

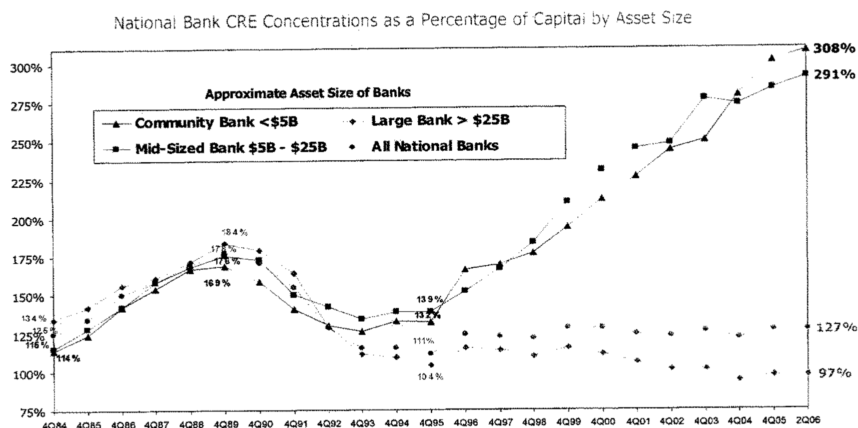
These bankers point out that commercial real estate has been a very strong business: the underlying collateral is real; demand has remained strong; and smaller banks can compete. In this context, bankers worry that the proposed guidance will cap or restrict their participation in one of their best performing sectors.

That is not what the guidance is intended to do. The guidance is intended to outline prudent risk management practices. Concentrations in commercial real estate lending – or in any other type of loan for that matter – do raise safety and soundness concerns. It is our job as regulators to focus institutions on ways to address those concerns. But our message is not, "Cut back on commercial real estate loans." Instead it is this: "You can have concentrations in commercial real estate loans, but only if you have appropriate risk management and capital to address the increased risk." And in terms of "the appropriate risk management and capital, " we are not referring to expertise or capital levels that are out of reach or impractical for community and mid-size bankers.

In response to some of the worries and misconceptions that have been expressed about the proposed guidance, let me provide more detail about three points: why regulators are concerned; what the guidance says to address those concerns; and, in practice, what the guidance really means and does not mean.

In terms of our concerns, today 35 percent of national banks hold commercial real estate loans in amounts exceeding 300 percent of capital. Nearly all of these institutions are mid-size or community banks which, as illustrated in the chart below, in the not-too-distant past rarely exhibited this degree of concentration in this type of lending.

CRE Loan Concentrations



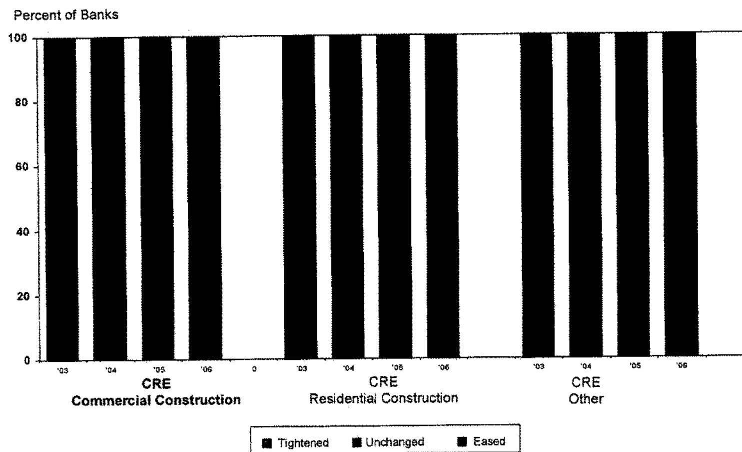
In some ways, the 45 degree slope of the red line speaks for itself, but let me provide some additional context about what it means. Not very long ago, if a national bank held loans of any type exceeding 300 percent of capital, that would have triggered a serious discussion with the board of directors about plans for diversification and possibly more capital.

Then as now, we emphasize the fundamental principle that loan concentrations require enhanced risk management from bankers, and enhanced scrutiny from supervisors. That is especially true if the concentration is in an asset category as volatile as commercial real estate – a business well known for its sharp and unpredictable turns. We saw this volatility most recently – and, for many bankers, disastrously – in the late

1980s and early 1990s. The degree to which banks participated in the run-up of the commercial real estate market in the early '80s proved to be one of the best predictors of subsequent bank failure. On average, banks that failed had nearly three times as many commercial real estate loans as a percentage of their total assets as banks that did not fail. Perhaps even more striking, all but the largest banks in that period had much lower concentrations in commercial real estate than they do today. For example, in 1989 nationally chartered community banks as a group had commercial real estate loan concentrations of approximately 169 percent of capital – compared to 308 percent today.

Thankfully, credit underwriting standards for commercial real estate lending today are much more rigorous than they were in the 1980s. Nevertheless, we have seen slippage at some banks in the last two years that has compounded our concerns with increased concentrations. Beginning in 2003, the OCC conducted a series of "horizontal" examinations – ones that focus on a single line of business across multiple institutions – in order to supplement and deepen our regular examination analysis. We found erosion in key areas: lengthening maturities, increasing policy exceptions, narrowing spreads, and lack of independence and quality control in the appraisal process. As the attached chart shows, our annual credit underwriting survey of the 73 largest national banks confirmed that standards for underwriting all types of CRE loans eased again in 2006. While underwriting standards generally remain acceptable, the easing trend is something we will continue to watch closely.

Commercial Real Estate Underwriting Trends



Our horizontal reviews also revealed that risk management practices had begun to lag the risks raised by increasing commercial real estate concentrations. Some banks demonstrated weaknesses in the fundamental risk management areas of board and management oversight, sound underwriting and internal controls, risk assessment, and monitoring – especially the type of monitoring that should be taking place through effective management information systems. In other cases, banks were not taking advantage of newer technological tools that help manage concentration risk, including basic risk management models and stress testing methods. These tools do exist; they are more powerful than ever before; and they are available to community and mid-size banks.

In short, while we believe that commercial real estate concentrations can be safely managed, *they must be effectively managed in order to be safe*. And because we were seeing weaknesses in that management, we issued the proposed guidance.

The basic premise of the new guidance is unchanged from the 1993 interagency guidance on commercial real estate lending, which the OCC updated and incorporated into a separate examination handbook in 1998. It is this: where commercial real estate loan concentrations exist, banks should have risk management systems and capital appropriate to the risk of those concentrations. Indeed, at its core, the proposed new guidance is simply a restatement and amplification of the supervisory guidance that the agencies developed in the wake of widespread bank failures precipitated by commercial real estate lending fewer than 20 years ago.

What the proposed guidance does for the first time is provide a simple definition of what we mean by commercial real estate concentrations. This definition is intended to answer the questions we have received over the years from many bankers frustrated with the ambiguity and lack of clarity of our previous guidance. Specifically, the proposed guidance provides more straightforward concentration thresholds that, once crossed, trigger expectations for enhanced risk management and capital levels. The first threshold is defined as those commercial real estate loans made for construction, land development, or other land that in the aggregate exceed 100 percent of capital. The second threshold applies when all commercial real estate loans made by a bank exceed 300 percent of capital. Importantly, the definition excludes farm loans, residential loans, and owner-occupied loans, where repayment depends upon the operating performance of a business, but does include unsecured loans to developers and REITs.

The agencies chose 100 and 300 percent as benchmarks after three years of intensive discussions involving experts from the private ratings agencies, the banking industry, and fellow regulators. These experts reported on their decades of experience in assessing commercial real estate lending and correlating it with risk. The degree of consensus on what constituted fair and reasonable benchmarks for concentration was striking, and that consensus translated into the benchmarks that the agencies unanimously proposed.

Having defined commercial real estate concentrations, the proposed guidance then sets forth the agencies' risk management and capital expectations for banks that have concentrations. Regarding the former, the guidance elaborates on the principles and components of an effective risk management program. For example, instead of simply invoking the importance of effective board and management oversight, the guidance discusses what that might include, such as timely reports on changes in market conditions and the bank's activity and risk profile. It further discusses the elements of a solid information system that allows management to better understand risk by tracking property type, geographic area, tenant concentrations, tenant industries, developer concentrations, risk ratings, and the like. And it describes in detail enhanced underwriting practices, so banks can take appropriate corrective action, if needed, before their next examination.

In terms of capital, the proposed guidance is more general: it says simply that banks with commercial real estate concentrations should hold capital higher than regulatory minimums and commensurate with the level of risk in their commercial real estate portfolios. While it is hard to argue with that basic proposition, commenters have

indicated considerable uncertainty about what it will mean in practice, just as there have been repeated questions about what we really mean by our discussion of effective risk management practices. I think it is important to address what the proposed guidance would mean in practice, and what it would not mean, including several of the misconceptions that surround the guidance.

Probably the most common concern expressed is that the 100/300 percent thresholds will quickly turn into hard caps – that is, examiners will apply the guidance in a way that will effectively leave banks no choice but to reduce their commercial real estate lending in order to reduce their concentrations to levels below the thresholds. Again, let me say categorically that this is not our intent. Far from being caps, these numbers are simply screens to determine where enhanced risk management and adequate capital is needed. Of course, those institutions that are unable or unwilling to make such enhancements should reduce or avoid concentrations, but that is a very different point from saying categorically that the thresholds are caps or limits. At the OCC, we are emphasizing this very point – that the thresholds are triggers for better prudential practices, not caps – in discussions with our examiners in every region of the country, and we plan to further clarify this point in any final guidance.

The other concern most often expressed involves the capital part of the guidance. Notwithstanding the actual language in the proposal, which is quite general, some bankers are worried that supervisors plan to seize the guidance as an opportunity to increase capital requirements for any institution exceeding the concentration thresholds. Again, that is certainly not the intent of the OCC. It is true that the proposed guidance calls for capital exceeding regulatory minimums for institutions that hold such

concentrations. But the simple fact is that the overwhelming majority of such institutions already hold capital cushions that exceed regulatory minimums by more than two hundred basis points, and, as a result, these institutions generally would not be affected by the capital adequacy part of the guidance.

More important, our focus in applying this guidance will be first and foremost on risk management practices. To the extent that an institution with a concentration exceeding one of the thresholds has enhanced risk management practices in place, or is moving in that direction, our concern with increased capital is greatly reduced. By the same token, an institution with a concentration but no prospect of enhancing risk management practices within a reasonable period of time would indeed be a candidate for capital above the regulatory minimums.

Finally, there is a certain amount of concern that the guidance will be implemented in an arbitrary and inconsistent manner, disadvantaging some lenders and benefiting others. In truth, one reason for issuing the guidance was that, over the decade since similar guidance was last issued, bankers had complained about growing variances in interpretation and application across charters and geographic regions. This was not only a source of frustration and confusion for the industry; it also tended to undermine the credibility of our regulations and supervision. Our new proposed guidance is intended in part to achieve greater consistency and a more level playing field among all financial institutions.

In closing, any discussion of the supervisory implications of commercial real estate lending inevitably evokes the banking crisis of more than a decade ago – a crisis in which commercial real estate lending clearly played a critical role and left an indelible

mark. It is hard to overstate the impact of that crisis on our economy, which ultimately left more than 1,600 banks closed or in need of government assistance and nearly bankrupted the deposit insurance fund. That experience profoundly affected the views of bank supervisors.

On the other side of the coin, many of us also have vivid memories of the so-called "credit crunch" of the early 1990s, when credit for commercial real estate became very difficult to find. Some argued that regulators had overreacted to the banking crisis by mandating overly restrictive underwriting policies, while others believed that bankers themselves were overreacting to the problems caused by past credit practices. Either way, it was a painful period from which it took a good bit of time to recover.

Needless to say, when it comes to commercial real estate, regulators and bankers should be doing all that we can to avoid <u>both</u> increased bank failures <u>and</u> a credit crunch. The best way to do that is to address smaller concerns effectively before they grow into much bigger problems that precipitate more extreme actions and reactions. That is precisely what the proposed guidance is intended to do. As a result, we will continue to work with our colleagues at the other agencies to address the concerns expressed in the comment letters and to clarify that our focus is on the importance of sound risk management practices.

Thank you very much.

STATEMENT

of

JIM GARNETT
HEAD OF RISK ARCHITECTURE FOR CITIGROUP

on behalf of

THE FINANCIAL SERVICES ROUNDTABLE

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

September 14, 2006

Chairman Bachus, and members of the Subcommittee on Financial Institutions and Consumer Credit, my name is Jim Garnett, and I am the Head of Risk Architecture for Citigroup. In that capacity, I am responsible for the implementation of the Basel II Capital Accord for Citigroup within the United States and other countries in which Citigroup operates.

I am here today on behalf of The Financial Services Roundtable ("The Roundtable"). The Roundtable is a national association of 100 of the largest integrated financial services firms in the United States. Roundtable members provide banking, insurance, securities, and investment products and services to consumers and business throughout the United States.

I would like to begin my testimony by emphasizing that The Roundtable strongly supports the implementation of the Basel II Capital Accord (the "Accord") in the United States. The existing Basel I regime has become outmoded for our larger institutions that routinely engage in sophisticated financial activities. Basel I does not accurately align regulatory capital with risk, and as a result has the perverse effect of rewarding banks that hold riskier portfolios, and penalizing banks that have more conservative banking practices. The U.S. needs to modernize its capital regulations, and there are a variety of new approaches that all represent a significant improvement over the current system, while the Basel I system could remain as an option for smaller community banks that maintain a traditional balance sheet. In a modern financial system, capital rules must be tied to economic risks. Inadequate regulatory capital requirements create safety and soundness concerns. On the other hand, excessive regulatory capital requirements constrain the lending and investment activities of the nation's banks and, thereby, reduce their ability to meet the credit needs of consumers and businesses.

The Accord establishes a three-part approach to capital regulation. Pillar1 provides for more risk-sensitive capital requirement for credit risk, market risk and operational risk. Pillar 2

requires that banks assess the need to provide additional capital, if any, for risks not covered by Pillar 1, such as credit concentration, and provides for supervisory review of a bank's capital adequacy and planning. Pillar 3 provides for market discipline through enhanced public disclosure. These three Pillars are intended to better align regulatory capital to underlying economic risks and to promote better risk management.

The Accord also is intended to promote consistency in international regulatory capital standards. While this goal is important for all banks, it is a particularly important aspect of the Accord for the members of the Roundtable that are active internationally. The harmonization internationally of a capital framework assures that all banks will be competitive when operating across national boundaries, and it avoids the significant compliance costs that would be associated with different capital regimes in different countries. It is important to emphasize, however, that competition and capital flows do not stop at national borders. Therefore, even those U.S. banks that have mostly domestic operations will be put at a disadvantage if foreign banks competing in the U.S. are subject to different capital standards.

Our concerns about the U.S. implementation of the Basel II framework, and the fact that the U.S. appears to be willing to significantly deviate from the international Accord, including the failure to provide U.S. institutions with a range of compliance options, led us to write to the four banking agencies on August 14 of this year. (A copy of the letter is attached to my testimony.) The proposed deviations from the international standards for the advanced approach, agreed to by all of the world's leading banking authorities, including our own regulators, will not only diminish the risk-sensitivity of this element of the Accord, but will also lead to unfavorable competitive disparities. I would like to elaborate on these concerns.

Diminished Risk Sensitivity

One of the key objectives of the Accord is to create an international capital framework that is more risk-sensitive than the Basel I regime. Creating a risk-sensitive capital regime is critically important for safety and soundness reasons:

- It aligns regulatory capital requirements with true economic risks.
- It recognizes the benefits of modern risk-mitigation techniques.
- It reduces the current incentives for institutions to shift their best assets off-balance sheet in order to achieve more favorable capital treatment.

Aligning capital with economic risk is also good for our economy. It ensures that adequate capital exists to cover risk, but does not result in excess capital requirements, which will have the economic effect of restraining the lending and investment capabilities of our financial institutions.

Unfortunately, the proposed U.S. version of the Accord includes a number of provisions that do not appear in the international Accord. These "add-on" provisions significantly diminish the risk sensitivity of the rule. For example, the proposed U.S. version includes a 10 percent limit on the amount aggregate minimum capital requirements may decline among Basel II banks. This is an arbitrary limit, which has no relationship to economic conditions. In strong economic cycles a drop in required regulatory capital of 10 percent or more may well be appropriate, and would not pose any safety and soundness concern. This provision also is unnecessary in light of Pillar 2, and the other supervisory tools currently available to the U.S. banking agencies to mandate an increase in minimum capital.

The U.S. regulators also plan on permanently retaining the existing minimum leverage ratio. This is a blunt regulatory instrument that requires an institution to hold a fixed percentage

of capital against total assets, regardless of risk. We recognize that the leverage ratio has had strong support in the Congress. However, over the past decade banks and regulators have made significant advances in risk management techniques. These advances are reflected in the international Basel II Accord, and it is important to objectively review whether the leverage ratio is still necessary in light of the new framework, or whether the leverage ratio is in fact counterproductive to achieving a modern risk based capital system.

For many banks subject to Basel II, the leverage ratio will become binding. In other words, more capital will be required to comply with the leverage ratio than to comply with the risk based minimums. As a result, banks that invest in less risky assets will be penalized for such a strategy, since the leverage ratio will not change no matter how conservative the bank operates. Rather, some banks may be motivated to acquire riskier assets until their regulatory capital and economic capital requirements are equalized.

Moreover, to the extent the leverage ratio results in a higher minimum capital requirement than justified by the risk presented by the bank's activities, the regulatory requirement will have the effect of reducing the flow of credit to the economy. It will also make U.S. banks a more attractive target for acquisition by foreign institutions that are not subject to an equivalent leverage requirement.

While we do not support the permanent retention of the leverage ratio as referred to in the draft US proposal, we do not object to retaining a modified leverage ratio rule during the capital floor periods as an additional safeguard to mange the transition from Basel I to Basle II.

Competitive Marketplace

Another basic objective of the Basel Capital Accord is to foster international consistency in regulatory standards. Again, the proposed U.S. version of the Accord would frustrate this objective. Foreign banks are not subject to the various "add-on" provisions that are proposed for U.S. banks. They also have been permitted to implement the Accord more rapidly than U.S. banks. As a result, foreign banks will have a distinct capital advantage over U.S. banks in international markets. This not only helps them capture international business, but also gives them an advantage in mergers and acquisitions.

Similarly, the SEC adopted capital rules for certain U.S. investment banks that are consistent with the original Accord, and to date have not indicated any intent to modify these requirements. Thus, these institutions, which actively compete with commercial banks both domestically and internationally, will do so under a different, more advantageous capital regime.

The Costs of Compliance

The difference between the proposed U.S. version of the Accord and the version that is being implemented in foreign countries also creates a costly compliance issue for large banks. Large banks already have sophisticated internal risk models and risk management systems that are designed to establish the levels of economic capital required to support their activities. As the U.S. version of the Accord deviates from a truly risk sensitive system, the relationship between the existing business internal models and systems and regulatory requirements diminishes. As a result, banks will be forced to spend, literally, millions of dollars to develop and maintain two parallel systems for measuring risk: one that will be used for business purposes, and another that will be used only for regulatory reporting purposes.

What is the Rationale For the Proposed U.S. Version of the Accord?

What explains the proposed U.S. version of the Accord? The most obvious answer is the quantitative analysis (the "QIS IV"). Preliminary results of that survey seemed to show that the original Accord could result in a significant decline in capital for large banks. That analysis raised safety and soundness concerns among Members of Congress, competitive concerns among smaller U.S. banks, and caused federal regulators to question the validity of the inputs used by large banks in the survey.

In our opinion, the QIS IV quantitative analysis has assumed a greater significance than is appropriate. First, it used the existing Basel I capital level as a baseline. If one of the key goals of Basel II is to replace the non-risk sensitive Basel I regime with a more risk sensitive capital regime that aligns regulatory capital to true economic risk, the limitations of using Basel I as the baseline for measuring reform need to be understood. Second, the QIS IV measured only Pillar 1 risks. It did not evaluate the potential effect of capital for Pillar 2 risks. Finally, and most significantly, the QIS IV analysis was conducted at an extremely strong point in the U.S. credit cycle. What this means is that it examined the impact of the Accord on credit risk at a time when, using a risk sensitive measure, minimum regulatory capital requirements would be expected to be lower since the risks to the banks are lower when the economy is robust and credit is strong.

The Roundtable has data that indicates that if the analysis had been conducted during a weak part of the credit cycle (e.g., the recession of 2001) the average minimum capital for large U.S. banks under the Accord would have shown an *increase* in capital levels over the Basel I minimum. Additionally, it is important to distinguish minimum capital requirements from the amount of capital an institution actually holds, which normally is well above regulatory

minimums. Thus, it is our view that the safety and soundness concerns that followed the release of the QIS IV analysis were, to a large degree, overstated. The Accord appropriately recognizes that minimum capital requirements should be reduced during good economic times, but then appropriately increased during difficult economic times.

Additionally, we would suggest that if a bank's capital plan called for excessive declines in capital, Pillar 2 of the Accord is the proper tool for addressing this. Pillar 2 is the supervisory review process that requires the regulators to assess a bank's capital planning processes.

With respect to the competitive concern of smaller banks, the federal banking agencies are addressing this concern through the development of the Basel IA proposal. Basel IA provides smaller banks with a more risk-sensitive capital structure, and may be an appropriate choice for many banks. The development of Basel IA is a constructive step in the implementation of the Accord in the United States, and we urge the federal banking agencies to publish the Basel IA NPR as quickly as possible.

Finally, we believe that concerns over the validity of existing internal models can be resolved by the rigorous validation requirements in the rule, as well as through the supervisory process. The large banks that use internal models have been doing so for years, and have demonstrated their reliability throughout all phases of the credit cycles. Further, the largest U.S. banks have fulltime, resident regulatory examination teams with detailed knowledge of and access to the bank's detailed capital management processes.

Our Recommendations

The answer to our concerns with the proposed U.S. version of the Accord is two-fold: (1) harmonize the U.S. version of the advanced approaches with the internationally negotiated text; and (ii) offer all U.S. banks the same options for compliance that are available internationally.

Harmonization of the advanced approaches would ensure that those institutions that choose to use the internal risk based models will have regulatory capital requirements that best reflects the risk of their assets. It will enhance competition on the international level. It will better align the actual business internal risk models and risk management systems with regulatory requirements.

Offering various compliance options is likewise critically important. Options for US banks should include the international Advanced approach and simpler approaches, which could include Basel 1A and the international Standardized approach. We would also suggest that for some small community based institutions, continued use of the existing Basel I standards may well be appropriate.

Giving banks a choice of methodologies for risk-based capital compliance has several benefits. It allows banks to choose among methodologies that are simple and transparent; it assures a competitive marketplace both domestically and internationally; it ensures appropriate minimum regulatory capital requirements; and it allows banks of all sizes to make their own cost/benefit assessments of the risk sensitivity of each option.

We acknowledge that the introduction of options at this point in the rulemaking process could result in some delay in the implementation of the Accord in the United States. We believe, however, that any delay should be minimal. A Basel IA notice of proposed rulemaking is expected to be released soon. The standardized approach (a summary of which is attached as an appendix) has been part of the basic Basel II framework. Its terms and conditions are set forth in great detail in the international Accord that the federal banking agencies approved in June 2004, and those terms and conditions are fully known and understood by the federal banking agencies.

On the whole, we do not believe material changes would be required and, therefore, the option can easily be incorporated into the U.S. version of the Accord.

Conclusion

The development and implementation of a risk-based framework for U.S. depository institutions that is consistent with the international community and creates a competitive marketplace is extremely important, both for purpose of safety and soundness, and to ensure that the capital resources of our nation's banks are optimized for the benefit of our economy. The Roundtable supports the development of a modern risk sensitive system, as developed by the world's leading developed countries represented on the Basel Committee on Banking Supervision. Regulators in Europe and elsewhere have implemented the agreement consistent with the original Accord. The current U.S. version of the Accord includes several provisions that have not been adopted by other countries, and does not give banks a choice of compliance methodologies, including the standardized approach. We urge the harmonization of the U.S. version of the Accord with the version that is being implemented in other countries, and giving all reasonable compliance options.

THE STANDARDIZED APPROACH

Risk-Weights for On-Balance Sheet Items

The current Basel I framework establishes a relatively unsophisticated risk-based capital standardized that places loans into broad categories, and does not evaluate counter-party risk. For example, all commercial loans are given the same risk weigh (100%) and all traditional mortgage loans are given the same weight (50%). The standardized approach significantly enhances the risk sensitivity of the capital requirement by recognizing that different counter-parties within the same loan category can present different risks. It also recognizes the value of various risk mitigation techniques. The following examples illustrate the enhanced alignment between risk capital under the standardized approach:

- Claims Against Corporations – Claims against corporations are assigned a risk weight according to the credit rating assigned to the corporation. Corporations with a credit rating of AAA to AA- are given a risk weigh or 20%, corporations with a credit rating of A+ to A- are given a risk weigh is 50%, corporations with a credit rating of BBB+ to BB- are given a risk weight of 100%, and corporations with a credit rating of less than BB- are given a risk weight of 150%. Unrated exposures receive a 100% risk weight.
- Retail Exposures (Loans to Individuals and Small Businesses) -- Loans to individuals and small businesses, including credit card loans, installment loans, student loans, and loans to small business entities are risk weighted at 75%, if the bank supervisor finds that the bank's retail portfolio is diverse. In comparison, retail and small business loans are placed in the 100% risk weight basket under Basel I.
- Residential Real Estate -- Prudently written residential mortgage loans are risk weighted at 35%. Although this capital charge is not adjusted for counter-party risk, the 35%

charge is closer to the actual risk of these loans than the 50% charge under Basel I.

- Commercial Real Estate Loans --In general, loans secured by commercial real estate are assigned to the 100 percent risk basket. However, the Accord permits regulators the discretion to assign mortgages on office and multi-purpose commercial properties, as well as multi-family residential properties, in the 50 percent basket subject to certain prudential limits. Under Basel I commercial real estate was assigned to the 100 percent basket.
- Claims Against Sovereign Governments and Central Banks – Unlike the current Basel I framework, which does not distinguish among OECD countries, the standardized approach assigns risk weights to Government debt based on the credit rating assigned by recognized Export Credit Agencies.

Off-Balance Sheet Items

Off-balance sheet items, such as loan commitments and guarantees, expose a financial institution to credit risk. Under Basel I no conversion (and thus no capital) is required for short-term exposures (one year or less). The standardized approach enhances risk sensitivity by converting short-term exposures using a 20% conversion factor. As in Basel I, longer term commitments are transferred using a conversion factor of 50%.

Credit Risk Mitigation

One of the most important differences between the standardized approach and Basel I is the acceptance of credit risk mitigation techniques. These techniques generally are not

recognized under Basel I. The standardized approach enhances risk sensitivity by recognizing credit risk mitigation techniques, such as the following:

- *Collateral* – The standardized approach affords banks two options for recognizing collateral. Under the first option, a bank may use the risk weight attributed to the collateral if it is lower than the risk weight of the counter party. Under the second option, a discount is applied to the value of the collateral, based upon the credit rating of the counter-party behind the collateral, or the bank may calculate its own discount based on internal models.

- Netting – While Basel I recognizes certain bilateral netting agreements for derivative contacts, the standardized approach recognizes a variety of legally enforceable netting agreements.
- Guarantees and Credit Derivatives – The standardized approach also improves risk sensitivity by recognizing third-party guarantees and credit protection contracts that meet certain conditions.

Standardized Approach - Securitizations

The standardized approach permits a bank to exclude securitized assets from the calculation of risk weighted assets if the credit risk associated with the assets have been transferred to third parties, and the bank does not maintain effective or indirect control over the transferred exposures. The assets must be beyond the reach of the bank and its creditors. However, the transferring bank may continue to service the assets. Banks that retain or acquire positions in a securitization, or have an off-balance sheet exposure in a securitization, are

required to hold capital with respect to these interests. The position is assigned a risk weight basket depending on the credit rating of the exposure. Originating banks must deduct from capital any "gain on sale" that results from the transfer of the asset into the securitization pool. If a bank sells revolving assets (e.g. credit card receivables) into a securitization structure that contains an early amortization feature, the bank will be required to hold capital against s specified percentage of the assets sold into the securitization (the investor's interest in the pool). The percentage increases as the excess spread account (which serves to protect security holders) declines.

Operational Risk

The Basel II Accord has three methods for determining a capital charge for operational risk: (1) the basic indicator approach, (2) the standardized approach; and (3) the advanced measurement approach (AMA). Under the standardized approach, a bank can select any one of these methods for setting capital on operational risk.

- Basic Indicator Approach -- Under this approach the operational risk capital charge is set at 15 percent of the institution's net positive annual gross income.
- Standardized Approach -- This method divides a bank's activities in eight business lines (e.g. corporate, finance, retail, asset management, etc.). Gross income for each of the eight lines is then multiplied by a specified factor, ranging from 12 to 18 percent. The Accord also recognizes an alternative under which outstanding loans are substituted for gross income with respect to retail and commercial banks.
- Advanced Measurement Approach (AMA) -- Under the AMA, the operational risk capital charge will be determined by using the bank's internal operational risk

measurement system. The Bank must track internal operational risk loss data and assess the relevance of that data to current operations. The data must capture all material activities and exposures in all systems and bank locations. External loss data must be used for events that are infrequent, yet potentially severe, such as an earthquake. Scenario analyses including expert opinion input must be utilized for high-severity events. The risk assessment should cover all key business environments and internal controls factors. Risk mitigation will be recognized. However, the recognition of third party insurance cannot exceed 20 percent of the total operational risk capital charge.

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RICHARD M. WHITING
EXECUTIVE DIRECTOR
AND GENERAL COUNSEL

August 14, 2006

The Honorable Ben S. Bernanke
Chairman
Federal Reserve Board of Governors
20th and C Streets, NW
Washington, DC 20551

The Honorable John C. Dugan
Comptroller of the Currency
250 E Street, SW
Washington, DC 22019

The Honorable Sheila C. Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable John M. Reich
Director
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Dear Chairman Bernanke, Comptroller Dugan, Chairman Bair, and Director Reich:

The development and implementation of a risk based capital framework for U.S. depository institutions is extremely important, both for purposes of safety and soundness and to ensure that the capital resources of our financial institutions are optimized for the benefit of our nation's economy. The Roundtable supports the development of a modern risk sensitive capital system, as developed by the world's leading economic countries represented on the Basel Committee on Banking Supervision.

Regulators in Europe and elsewhere have agreed upon a framework by which to implement the international Accord. We are concerned that the implementation of the Basel framework in the U.S. may deviate significantly from the international framework. The deviation reflected in the draft rule will result in a less risk-sensitive framework and will not reflect the capital modeling actually used by many of our more sophisticated institutions. Further, it would create competitive disparities with foreign competitors

that would disadvantage U.S.-based financial organizations. For foreign banks with a U.S. presence, it creates home/host compliance problems.

In light of these concerns, we respectfully urge you to re-align the notice of proposed rulemaking ("NPR") with the Basel II Accord as the process moves forward. This would more closely align the framework with actual market and business risks. We urge the prompt conclusion of the rule making process.

We also strongly recommend that you give all banking organizations a choice of compliance methodologies, which could include the standardized approach, as set forth in the November 2005 revisions to the Accord.

The proposed changes we advocate on behalf of Roundtable member companies would harmonize the NPR with international standards, and permit U.S. regulators to move to greater mutual acceptance of capital standards with international regulators.

Sincerely

Richard M. Whiting
Executive Director and General Counsel

Catherine A. Allen
CEO, BITS

TESTIMONY OF
MARC E. LACKRITZ
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION

BEFORE THE
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

UNITED STATES HOUSE OF REPRESENTATIVES

"A REVIEW OF REGULATORY PROPOSALS ON BASEL CAPITAL AND COMMERCIAL REAL ESTATE"

September 14, 2006

CSE: A Framework for Prudential Supervision

Mr. Chairman and Members of the Subcommittee:

My name is Marc Lackritz, and I am President of the Securities Industry Association (SIA).[1] I appreciate the opportunity to testify today on Basel II as incorporated into the Securities and Exchange Commission's ("SEC") framework for Consolidated Supervised Entities ("CSE"). Capital adequacy and prudential supervision are absolutely fundamental to the regulation of the financial services industry, and we commend the subcommittee for holding this timely hearing.

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[1] The Securities Industry Association brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2005, the industry generated an estimated $322.4 billion in domestic revenue and an estimated $474 billion in global revenues. (More information about SIA is available at: www.sia.com.)

My testimony will focus on three key points: 1) the origin of CSE; 2) how the CSE structure operates; and 3) a brief discussion of how well the framework has worked in practice.

Evolution of Framework

In response to global competition and customer demand for new products and services over the last several decades, the number of large financial conglomerates has grown significantly. These financial intermediaries – banks, brokers, and insurers – no longer engage solely in activities that have traditionally been regulated on a purely functional basis. As a result, both regulators and market participants recognized the need to obtain a comprehensive view of *all* of a firm's activities, as distinct from an individual line of business. The risk of potential systemic problems in the capital markets led to the conclusion that a form of *consolidated* supervision of such conglomerates was necessary.

In early 1996, the Joint Forum on Financial Conglomerates ("Joint Forum") was established under the sponsorship of the Basel Committee on Banking Supervision (the group responsible for the various Basel Capital Accords), the International Organization of Securities Commissions, and the International Association of Insurance Supervisors to deal with issues common to the banking, securities and insurance sectors, focusing especially upon oversight of financial conglomerates. In early 1999, the Joint Forum published a collection of papers on this subject under the title of "Supervision of Financial Conglomerates."[2] That document proved to be very influential in Europe, particularly in the context of the European Union's ("EU") Financial Services Action Plan ("FSAP")[3] that was developed to create a single market in financial services throughout the EU.

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[2] *Supervision of Financial Conglomerates*" Papers prepared by the Joint Forum on Financial Conglomerates, February 1999.

[3] The FSAP is a set of 42 separate legislative and non-legislative measures in banking, insurance and securities, which collectively provides a plan for European financial services market integration. It groups the various proposals into three broad categories: 1) the development of a single EU institutional market; 2) open and secure retail markets; and 3) developing state-of-the-art prudential rules and supervision.

One of the top FSAP priorities was the development of legislation for the prudential supervision of financial conglomerates, which ultimately resulted in a document entitled the Financial Conglomerates Directive ("FCD").[4] The FCD mandates that any financial firm with significant operations in the EU demonstrate that it is subject to and in compliance with a regime of consolidated supervision. Under the terms of the FCD, any non-EU firm must prove that it is subject to consolidated supervision by its home regulator that is "equivalent" to that required of EU firms. A failure to demonstrate equivalency would require that the firm's EU operations be "ring fenced" from the remainder of its global activities, and that it have an EU regulator undertake supervision of its EU-based operations. Although London is the most significant location for the EU-based transactions of U. S. securities firms, the United Kingdom's lead financial regulator, the Financial Services Authority, expressed doubts about its ability to adequately supervise a non-EU-based financial conglomerate.[5]

Similarly, EU representatives – after discussions with the SEC in 2001 and 2002 – expressed doubt that the SEC's existing supervisory regime applicable to the material affiliates of broker-dealers would be judged "equivalent" to the EU requirements. Consequently, the SEC undertook to craft a new regulatory framework for consolidated supervision of major independent investment banks not otherwise subject to consolidated supervision. The agency published the initial CSE proposal in October 2003[6] and received more than 20 responses from private and public commentators, both foreign and domestic. The SEC then made a number of amendments to the proposal and finalized the CSE framework in June 2004.[7]

[4] The FCD was finalized in December 2002, and made applicable to firms with financial years beginning on or after January 1, 2005. Directive 2002/87/EC of the European Parliament and of the Council, 16 December 2002.

[5] "We do not believe that it will generally be feasible for the EU coordinator to achieve the oversight of major third country [i.e., non-EU] banking and investment groups and conglomerates necessary to assess whether they have adequate capital and adequate systems and controls and management at the top of the financial group. . . . . It is not likely, therefore, that we will apply worldwide group supervision to [such] banking and investment or financial conglomerate groups." "Financial groups," Consultation Paper 204, p. 45, FSA and HM Treasury, October 2003.

[6] Rel. No. 34-48690 (Oct. 24, 2003), 68 Fed. Reg. 62872 (Nov. 6, 2003).

[7] Rel. No. 34-49830 (June 8, 2004), 69 Fed. Reg. 34428 (June 21, 2004).

Operation of Framework

Overview -- Under the CSE framework, the SEC supervises certain broker-dealers, their holding companies, and affiliates on a consolidated basis, focusing on the financial and operational status of the entity as a whole. The goal is two-fold: first, to reduce the possibility that some problem within the holding company and/or an unregulated affiliate could endanger regulated entities; and second, to reduce any potential systemic threat to the capital markets as a whole.

Parallel with the requirements of other global consolidated supervisors, the CSE framework incorporates significant elements of Basel II.[8] Although Basel II was not yet in effect when the first CSE applications were approved, it is an element of the new framework. Partly this was due to its status as an internationally agreed capital standard, and partly based upon practical considerations. Otherwise, the CSE applicants would have had to bear the cost of implementing Basel I on a firm-wide basis only to replace it with Basel II shortly thereafter. The CSE framework permits the broker-dealer of a CSE registrant that is judged as having strong internal risk management practices to utilize their own mathematical modeling methods, such as value-at-risk ("VaR") models and scenario analysis, to compute their capital requirements. The SEC must be notified if the broker-dealer's capital falls below $5 billion.

Application process -- In reviewing a CSE application, the SEC staff assesses the firm's financial position, the adequacy of the firm's internal risk management controls, and the mathematical models the firm will use for internal risk management and regulatory capital purposes. The staff also conducts on-site reviews to verify the accuracy of the information included in the application, and to assess the adequacy of the implementation of the firm's internal risk management policies and procedures.

[8] Facing severe time constraints, the first SEC approved CSE applicant utilized Basel I, but subsequent applicants implemented Basel II.

Additionally, a firm's ultimate holding company must consent to group-wide consolidated supervision by the SEC. Among other things, the firm's holding company must agree to:

- Maintain and document an internal risk management control system for the affiliate group;
- Calculate a group-wide capital adequacy measure consistent with Basel Standards;
- Agree to SEC examination of the books and records of itself and its affiliates, where those affiliates do not have a principal regulator;
- Regularly report its financial and operational condition, and make available to the SEC information about itself or any of its material affiliates; and
- For those affiliates that are not subject to SEC examination, make available examination reports of their principal regulators.

Continuing oversight -- Following approval, the SEC staff reviews monthly, quarterly, and annual filings containing financial, risk management, and operations data on the CSE registrant. These reports include consolidating financials (which show inter-company transactions not included in the preparation of consolidated financial statements) and risk reports substantially similar to those provided to the firm's senior managers. At least monthly, the holding company files a capital calculation made on a consolidated, group-wide basis consistent with Basel standards.

Additionally, the SEC staff meets at least monthly with senior risk managers and financial controllers at the holding company level to review the packages of risk analytics prepared at the ultimate holding company level for the firm's senior management. The focus is on the performance of the risk measurement infrastructure, including statistical models; risk governance issues, including modifications to and violations of risk limits; and the management of outsized risk exposures. There are also quarterly meetings to review financial results, the management of the firm's balance sheet, and, in particular, balance sheet liquidity. Also on a quarterly basis, SEC staff meets with the internal audit department to discuss audit findings and reports that may bear on financial, operational,

and risk controls. These regular discussions are augmented with focused work on risk management, regulatory capital, and financial reporting issues.

In conjunction with the staff of relevant self-regulatory organizations, SEC staff also conducts examinations of the books and records of the registered broker-dealer and material affiliates that are not subject to supervision by a principal regulator. The examinations focus on the capital calculation and on the adequacy of implementation of the firm's documented internal risk management controls.

Perception of the Framework

The first CSE applicant was approved on December 23, 2004 with four additional applicants gaining approval between March and November 2005.[9] Shortly after publication of the final CSE framework by the SEC in July 2004, the EU provided general guidance indicating that the framework is "equivalent" to the form of consolidated supervision required under the FCD. And with the U.K.'s FSA acting on behalf of the EU, that finding has been subsequently affirmed in its having made equivalence decisions for each of the individual CSE registrants.

There are at least two dimensions to these equivalency determinations. The CSE framework itself had to demonstrate that it established a high standard for a registrant's internal controls, risk management infrastructure, and capital resources, and that it would be applied in a rigorous fashion by regulators. But it was also necessary to show that cooperation of supervisors across borders would be a central feature of the framework. Each of the CSE firms has large and important affiliates that are functionally regulated in other jurisdictions, in large measure by the FSA in London. While the SEC – as the home regulator – must take the lead in overseeing these firms, foreign regulators have an understandable and perfectly legitimate interest in knowing the overall financial

[9] On August 11, 2006, the SEC approved an application that will permit the broker-dealer of a bank holding company already subject to consolidated supervision to utilize the alternative method of computing net capital set forth in CSE. But as the SEC does not purport to provide consolidated supervision of the entity as a whole, strictly speaking it is not a CSE firm *per se*.

condition of the holding company, and obtaining some comfort that the local entity will not be imperiled by events elsewhere in the group. A structure had to be created that facilitates a high level of cooperation between U.S. and foreign regulators. The EU decision on CSE equivalency is a clear statement that the framework is a solid success.

Conclusion

While all five CSE firms found the examination and implementation of the CSE framework challenging and rigorous, they also found it to be flexible and practicable. We wish to congratulate the SEC for the implementation of a new framework for consolidated supervision in a very timely fashion. It required a great deal of work by the Commission and its staff in a relatively short period of time, and we regard it as an excellent example of prudential supervision.

The CSE firms also wish to thank this Committee – and members of the Administration, particularly Treasury – for their interest in learning about the CSE framework, and most importantly in ensuring that the process of finding of "equivalency" by the EU was both fair and timely.

Thank you.

INDEPENDENT COMMUNITY
BANKERS of AMERICA

Testimony
by
James H. McKillop
President/CEO
Independent Bankers' Bank of Florida
Lake Mary, FL

on behalf of

Independent Community Bankers of America
Washington, DC

"A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate"

United States House of Representatives
Committee on Financial Services;
Subcommittee on Financial Institutions
and Consumer Credit

September 14, 2006

Mr. Chairman, ranking member Maloney, and members of the subcommittee, my name is James H. McKillop, III. I am President and CEO of the Independent Bankers' Bank of Florida. I am also a member of the Federal Legislation Committee of the Independent Community Bankers of America[1]. ICBA welcomes the opportunity to testify on the bank regulatory agencies' proposed guidance on commercial real estate lending and on the agencies' proposed rulemaking to implement the Basel II rules. This statement will first address the CRE lending guidance and then turn to the Basel II rulemaking.

I want to compliment this subcommittee for taking up these difficult regulatory issues late in the Congressional session. These proposals deeply affect community banks and their ability to serve their communities. Your continued oversight is very important.

Let me tell you something about me and the Independent Bankers' Bank (IBB). I am a 6th generation Floridian; my family started there in the title business. The business of my bank is concentrated in commercial real estate lending. We have CRE loans equal to 600% of capital, 7 1/2 percent Tier 1 capital and a $3 million dollar allowance for losses.

The IBB serves the loan, operational, and investment services needs of over 270 community banks throughout Florida, and the southern portions of Georgia and Alabama. Of those customers, 135 own shares in the Bankers' Bank. As a bankers' bank, we offer services only to community banks, not to the general public. This unique focus on community banks has given me an opportunity to hear and address the business challenges faced by community banks throughout the region that we serve. We are headquartered in Lake Mary, Florida. As of June 2006, IBB's total assets were nearly $435 million and we administered over $2.0 billion in total resources.

Commercial Real Estate

The Office of the Comptroller of the Currency, Board of the Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of Thrift Supervision have propose regulatory guidance entitled, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.* The proposed guidance would require banks with concentrations in commercial real estate[2] lending (CRE) to tighten risk management practices and potentially

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[1] The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace. For more information, visit ICBA's website at www.icba.org.

[2] The proposed guidance defines CRE loans as exposures secured by raw land, land development and construction (including 1-4 family residential construction), multi-family property and non-farm nonresidential property where the primary or significant source of the repayment is

increase capital. The proposal contains thresholds for determining whether or not an institution has a CRE concentration. According to the proposed thresholds, many community banks would be considered to have a concentration in CRE lending.

Summary of ICBA Views on CRE Guidance
ICBA is gravely concerned that the proposed guidance is seriously flawed and we have strongly urged the banking agencies not to go forward with it in its current form. ICBA has received many communications from bankers about the proposed guidance and they are overwhelmingly negative. The regulators have received over 1,000 letters, many raising concerns about the proposal.

Community bankers view the proposal as overly broad, defining concentrations of risk in a manner that can not assess the true risk in a bank's CRE lending. Bankers are greatly concerned that they will need to rein in their CRE lending, if the guidance goes forward in its current form, though they do not believe that the risk in their portfolio warrants it. If they must decrease their CRE exposure, they will decrease their ability to meet the lending needs of their growing, thriving communities. Banks will suffer financially and so will their communities.

Community banks question the need for this new guidance; they believe that the existing body of real estate lending standards, regulations and guidelines is sufficient to guide banks through any weakness in the CRE market. Examiners already have the necessary tools to enforce rules and regulations and address unsafe and unsound practices; thus community banks view the new guidance as unnecessary. They particularly object to the proposed concentration thresholds as they believe the thresholds can give a misleading picture of risk exposure.

Banking regulators have stated that they have identified problems in "some" banks, yet they would apply this guidance in a broad brush approach across the entire industry, assuming many banks have problems. Instead, we believe that examiners should identify and address CRE lending and risk management problems, bank by bank.

While community banks are already employing many of the recommended risk management principles, they view the recommendations regarding stress testing and management information system improvements as costly, burdensome and unnecessary for banks that already closely monitor their loans and customers.

For these reasons, ICBA has strongly urged the banking regulators not to go forward with this flawed guidance as it was proposed.

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derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risk in CRE markets would also be considered CRE loans for purposes of the guidance.

Background on CRE Proposal
When issuing the proposal, the banking agencies stated they had observed that some institutions have high and increasing concentrations of commercial real estate loans on their balance sheets, potentially making them more vulnerable to cyclical commercial real estate markets. The regulators were particularly concerned about concentrations in CRE loans where the source of repayment is primarily dependent on rental income or the proceeds of the sale, refinancing or permanent financing of the property. These loans may expose institutions to unanticipated earnings and capital volatility due to adverse changes in the general commercial real estate market, the agencies state. The banking regulators have said that examinations have indicated that risk management practices and capital levels of some institutions are not keeping pace with their increasing CRE concentrations.

The proposal is intended to reinforce existing guidance relating to institutions with CRE concentrations. The banking regulators state that this guidance is intended to focus on concentrations in CRE that are particularly vulnerable to cyclical commercial real estate markets.

Many community banks are likely to be effected by the proposal. The FDIC estimated CRE loans constitute 258% of capital of the 8,235 banks with less than $1 billion in assets. Many of these banks have relied on commercial real estate lending for growth and profitability and may not have as diverse a portfolio as banks with assets greater than $1 billion due to the more limited markets they serve. CRE lending has made up at least two-thirds of asset growth at community banks each year since 2001; a record 28% of total community bank assets were in CRE loans as of March 2005.

ICBA Views on CRE Guidance
Community bankers recognize that they should prepare for any significant downturns in the CRE market; they are very concerned that the proposed guidance will unnecessarily constrain their ability to meet the needs of their commercial real estate customers. **Many community banks view the proposal as a call to cut back on CRE lending. If a community bank must cut back, it means cutting back on one of its more profitable business lines. But it also means less money will be available to support community growth.** This is a particular concern to community banks serving smaller communities and communities that have seen an influx of new businesses and residents. Community banks have told ICBA that they can and do manage their CRE portfolios in a safe and sound manner.

ICBA has urged the regulators to abandon the proposed concentration thresholds and look at an institution's credit risk and risk management practices on a case by case basis. **ICBA believes that the proposed threshold tests to determine whether or not an institution has a concentration in commercial real estate loans are seriously flawed and do not give a clear picture of risk.** They do not take into account the lending and risk management practices of individual institutions. They do not recognize that different segments of the CRE

markets have different levels of risk. Many community banks that exceed the threshold tests point out that they have gone through the difficult credit cycles in the 1980s and 1990s with less capital than they have now. They have learned from past mistakes and have more capital and stronger risk management systems than in the past and are now better equipped to handle future downturns.

Community banks underwrite and manage CRE loans in a conservative manner, requiring higher down payments or take other steps to offset credit risks and concentrations. They carefully inspect collateral and monitor loan performance and the borrower's financial condition. Community bankers lend in their communities and are close to their customers. Community banks believe they do a better job monitoring these loans than do large nationwide lenders because they are more likely to work one-on-one with the customer. They are positioned well to know the condition of their local economy and their borrowers.

While many community banks already have capital in excess of current minimum standards, they are concerned that the proposal calls for even higher levels simply because their CRE lending exceeds the proposed thresholds without any analysis of the actual risk. The proposed guidance is unfairly burdensome for community banks that do not have opportunities to raise capital or diversify their portfolio to the extent that larger regional banks can. The CRE portfolios of many community banks have grown in response to the needs of their communities. If community banks are pressured to lower their CRE exposures, their ability to generate income and more capital will be constrained and they will loose good loans to larger competitors.

The proposal's recommendations regarding management information system reports will be particularly costly and burdensome to community banks; the costs will most likely out weigh the benefits for smaller banks. They find the guidance regarding stress testing of the portfolio and changes to the management information systems called for by the guidance to be particularly burdensome.

ICBA is also concerned that market analysts will misapply the guidance when analyzing banks, using the thresholds to treat all CRE loans as having equal risk without taking into account the quality of underwriting standards and risk management practices or risk levels of individual loans when making buy, sell or hold recommendations. Thus the public will be misled about the true risk in a bank's portfolio.

Comments on Aspects of the Proposal

Thresholds for Assessing "Concentration"
In proposing the guidance, the banking agencies focused on concentrations in those types of CRE loans that are particularly vulnerable to cyclical commercial real estate markets. These include CRE exposures where the source of repayment primarily depends upon rental income or the sale, refinancing, or

permanent financing of the property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risk in CRE markets would also be considered CRE loans for purposes of the proposed guidance.

The banking regulators propose thresholds for assessing whether an institution has a CRE concentration and should employ heightened risk management practices. According to the proposal, if an institution exceeds or is rapidly approaching the following thresholds, it has a concentration in CRE loans:

1. Total reported loans for construction, land development, and other land[3] representing 100% or more of total capital;[4]

   OR

2. Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land[5] represent 300% or more of total capital.

If the bank exceeds threshold (1), it should have heightened risk management practices appropriate to the degree of CRE concentration. If the bank exceeds threshold (2), it should further analyze its loans and quantify the dollar amount of those that meet the definition of a CRE loan. If the institution has a level of CRE loans meeting the CRE definition of 300 percent or more of total capital, it should have heightened risk management practices described in the guidance. The guidance may also be applied on a case-by-case basis to any bank that has had a sharp increase in CRE lending over a short period of time or has a significant concentration in CRE loans secured by a particular property type.

Owner occupied loans are excluded from this guidance because their risk profiles are less influenced by fluctuations in the market. ICBA agrees that owner occupied loans should be excluded from the calculations as they pose less risk, but we also believe that loans made for the construction of 1-4 family homes should be excluded since they will be owner-occupied, and thus less influenced by market fluctuations. We also urged the banking agencies to clarify the meaning of "owner-occupied" since it is not currently defined and is unclear, such as when a loan is for a mixed use property when only a portion is owner occupied. In our view when an owner occupies at least a portion of the building, the risk profile is lowered.

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[3] For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C item 1a. For Savings associations as reported in the Thrift Financial Report, schedule SC lines SC230, SC235, SC240, and SC265.

[4] Total capital is the total risk-based capital as reported in Call Report (FFIEC 031 and 041 schedule RC-R-Regulatory Capital, line 21). For savings associations as reported in the Thrift Financial Report, CCR, Line CCR39.

[5] For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C items 1a, 1d, and 1e. For savings associations as reported in the Thrift Financial Report Schedule SC lines SC230, SC235, SC240, SC256, SC260 and SC265.

While the use of such thresholds could facilitate the monitoring of a particular bank's level of CRE lending and the level of CRE lending in the industry overall, we do not believe that their use will give a reliable picture of the true level of risk in a particular institution or the industry. **The proposed thresholds can not capture true risk because they can not take into account underwriting standards and risk management practices. The thresholds treat all loans within the calculation as having equal risk.** For example, the second threshold test assumes loans secured by multifamily properties to have the same risk as land development loans, yet multifamily properties have historically preformed far better.

Further, the proposed thresholds can not truly identify a concentration. For example, a community bank with $100 million in assets with $80 million in loans and 8 percent capital could reach the first threshold with just $8 million in loans and the second threshold with $24 million in loans. This would represent only 10 percent and 30 percent of the entire portfolio, respectively, and does not truly imply a concentration.

Banking is about making judgments and managing risk. **We are concerned that the proposal would inappropriately replace judgments with "pass/fail" tests. Community banks are concerned that the proposed thresholds will be arbitrarily used by examiners to assess risk: exceed them and the bank is automatically a high risk institution and should raise more capital, without sufficient regard to risk mitigating factors.**

Each institution, its community, and thus its business, is different. Banking regulators send examination teams on site because that is the best way to ensure that they have a true picture of an institution's financial condition and risk management. We do not think arbitrary thresholds can replace this close up perspective.

Application of Guidance By Market Analysts

ICBA has been greatly concerned that market analysts would apply the proposed guidance as they analyzed the financial conditions of banks. In June, ICBA wrote to the banking regulators about an article published on RealMoney and republished on The Steet.com (attached) that raised a very serious concern about the guidance. In it, the author Richard Suttmeier, president of Global Market Consultants, Ltd. and chief market strategist for Joseph Stevens & Co, applied the proposed concentration thresholds to the six largest banks in the country and recommends adding to or reducing positions in their stocks, based only on price targets and on their percentage of CRE loans to capital. For example, he recommended that investors buy Bank of America stock because its ratio is "29%, below the FDIC 100% threshold" whereas he recommends immediately reducing holdings of BB&T Bank because its CRE loans are "way above the FDIC's red line at 197%" for one threshold and "above danger levels at 364%" for the second threshold.

Clearly, this analyst saw the proposed concentration thresholds as absolute cutoff levels, stating that when a bank's commercial development loans exceed 100% of capital, "it's a warning." When CRE loans exceed 300%, "it's a danger sign." The banking regulators stated that the proposed guidance is intended to reinforce existing guidance for institutions with CRE concentrations and indicate when they need to tighten risk management practices and potentially increase capital. **Yet, the proposed thresholds of concentrations are being treated by this analyst as new buy/sell indicators for investment transactions, regardless of other business or financial indicators for a financial institution. We are extremely troubled by the application of the proposed guidance in this manner.**

Risk Management Principles
The agencies proposed several risk management principles to reinforce a safe and sound real estate lending program.

Board Oversight
The proposal points out that the board of directors has the ultimate responsibility for the level of risk taken by the institution. Therefore, the board or a board committee should approve the overall CRE lending strategy and policies and receive reports on the CRE market and lending activities. The board should periodically review and approve CRE aggregate risk exposure limits and appropriate sublimits to correspond with changes in strategies or market conditions. The board should also ensure that management compensation policies are compatible with the institution's strategy and do not create incentives to assume unintended risks. **This is the approach already in place in community banks.**

Strategic Plans
The bank must include the rationale for its CRE levels in its strategic plan, analyze the effect of a downturn on earnings and capital, and have a contingency plan. The agencies require that each bank adopt and maintain a separate written policy that establishes appropriate limits and standards for all loans secured by real estate. Loans exceeding the interagency loan-to-value (LTV) guidelines should be recorded and reported to the Board. Examiners will review these reports to determine if they are adequately documented. **Community banks have told ICBA that they do not view this as a change from their current practices.**

Secondary Market Underwriting
According to the proposal, when a bank's underwriting standards are substantially more lenient than the secondary market standards, management should justify the reasons why the risk criteria deviate from those of the secondary market. Community banks have great difficulty in underwriting their CRE loans to secondary market standards. For many of the CRE loans that community banks make, there isn't a ready secondary market—certainly not like that which exists for residential mortgages. Many of the loans are for projects that are too small or that have characteristics that make them unsuitable for

securitization. Many community banks still hold residential mortgages in portfolio because they do not meet secondary market underwriting standards, but that does not make them inherently riskier. In our view, the same can be said for CRE loans. **Thus, this portion of the guidance is not practical for community banks and many of the CRE loans they make.**

The regulators also suggest that banks use secondary market sales or securitizations to manage concentration levels. This is not a realistic option for many community banks. While they may be considered to have a concentration of CRE loans, due to their size, it does not equate to a large volume of loans. Secondary markets and securitizations depend on volume and community banks often are frustrated because they do not have sufficient volume for these to be viable options.

Risk Assessment

According to the proposal, banks must measure and control commercial real estate risk at the portfolio level by identifying and managing concentrations, performing market analysis, and stress testing. The proposed guidance states that a bank's management information system (MIS) should provide meaningful information on CRE portfolio characteristics that are relevant to the institution's lending strategy, underwriting standards and risk tolerances. Banks are encouraged to analyze the portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating. The system should maintain the appraised value at origination and subsequent valuations. Other measurements should include loan structure, loan type, loan-to-value limits, debt service coverage, and policy exemptions.

Banks are encouraged to stress test the CRE portfolio against changing economic conditions. The agencies state they realize stress testing is an evolving process and encourage banks to consider its use as a risk management tool and to periodically review the adequacy of stress testing practices relative to CRE risk exposures. The complexity of a bank's stress testing practices should be consistent with the size and complexity of its CRE loan portfolio.

Community banks believe that the proposal's recommendations regarding MIS enhancements and stress testing are particularly costly and burdensome to community banks; the costs will most likely out weigh the benefits for smaller banks, with the result being an unwarranted and unnecessary contraction in CRE lending. While by the proposed thresholds a community bank may be deemed to have a concentration in CRE loans, it may not equate to a large number of loans due to the bank's size. Community banks typically operate in a limited geographic area, enabling them to closely monitor the economic status of individual borrowers, the industry and the community. **Thus, we do not believe that the regulators should put out a general call for increased MIS systems and stress testing. Rather they should look at the particular needs of an institution during the examination process and urge enhancements when they find that existing systems and are lacking.**

Capital Adequacy
The proposal states that minimum levels of regulatory capital do not provide banks with a sufficient buffer to absorb unexpected losses arising from loan concentrations. A bank with a CRE concentration should recognize the need for additional capital support for CRE concentrations in its strategic, financial, and capital planning, including an assessment of the potential for future losses on CRE exposures, the guidance says. Institutions with high or inordinate risk are expected to operate well above minimum capital requirements. In assessing capital adequacy, regulators will consider the bank's analysis, the level of risk in the portfolio and the quality of the bank's risk management practices.

Most community banks already hold capital levels well above regulatory minimums and are concerned that the proposed guidance could require them to hold even more. **We question whether the proposed guidance regarding capital levels is consistent with risk based capital requirements currently in place that assess capital adequacy based on risk inherent to an asset class and consistent with existing regulatory requirements that tie capital requirements to loan-to-value ratios.**

ICBA has urged the banking regulators to not arbitrarily require banks to hold more capital (or require them to decrease CRE lending) simply because they pass certain thresholds of CRE loans to capital. Community banks believe the suggestion that they would need more capital if they are identified as having a CRE concentration does not recognize the fact that risk-based capital standards can and should address risk based on asset risk. Guidance pertaining to capital should be consistent with existing capital rules and guidance.

The allowance for loan losses is another means of protecting an institution that should be a consideration in determining the effects of potential concentrations on capital adequacy. However, banks should not be required by their regulators to increase their reserves based on arbitrary tests for the amount of CRE loans, a measure that may or may not be a true indicator of loan losses.

Hurricane and Other Disaster Areas
The proposed guidance is particularly troublesome for community banks located in areas affected by Hurricanes Katrina and Rita and other disaster areas where rebuilding efforts are very likely to cause them to have CRE concentrations. We have urged the regulators that should they go forward with this guidance, to either exempt community banks operating in these locations from the guidance or provide them maximum flexibility to continue their support of rebuilding efforts.

Summary and Recommendations on CRE Guidance
ICBA strongly urged the banking regulators not to go forward with the guidance as proposed. Regulators should instead rely on existing rules, regulations and guides for management of risks in CRE lending to ensure banks take appropriate steps to protect their safety and soundness when they are experiencing high levels of lending growth, particularly in industries such as CRE where history demonstrates that significant downturns can occur.

Community banks object strongly to the proposed thresholds for determining CRE concentrations as they do not believe that they are reliable measures of the true risk in an institution. Community banks have taken significant steps since previous CRE downturns; they underwrite loans conservatively, have better staff resources and higher capital and thus are in a better position to withstand weakness. Because they lend in limited geographic areas and typically have a close customer relationship, they are in a good position to closely monitor their CRE loans and economic factors impacting them.

The banking regulators should address problems on an individual bank basis, rather than issue broad "one size fits all" guidance that may cause community banks to curtail their CRE lending when it is not necessary for safety and soundness. If a broad message is sent across the banking industry that absolute levels of CRE lending are inherently unsafe and unsound, banks will respond and cut back on CRE lending, which will unnecessarily curtail their earnings ability and the growth of their communities.

We urged the regulators not to go forward with the guidance as proposed and instead send a clear message to banks and their examiners that growth in CRE lending can occur, consistent with safety and soundness, when banks take the steps to manage it properly.

Basel II and Basel IA

This subcommittee has played a key oversight role in the development of the United States' position on Basel II. Legislation members introduced last year, the United States Financial Policy Committee For Fair Capital Standards Act (H.R. 1226), clearly signaled that you expected the views of every agency and type of institution considered in this process.

Last week, the banking agencies issued for comment a notice of proposed rulemaking (Basel II NPR) that would implement new risk-based capital standards in the United States for large, internationally active banking organizations. The proposed Basel II rules would require some and permit other banks to use an internal ratings-based approach (IRB) to calculate regulatory credit risk capital requirements and advanced measurement approaches (AMA) to calculate regulatory operational risk capital requirements. Banks with consolidated total assets of $250 billion or more or with consolidated total on-balance sheet foreign exposure of $10 billion or more would be subject to the proposed Basel II rules. Other banks would have the opportunity to opt-in to the new capital standards provided they receive the approval of their primary federal supervisor.

Summary of ICBA's Position on Basel II and IA

- Although ICBA commends the banking agencies for their decision to retain the leverage capital ratio as part of Basel II and to include other safeguards during the transition period, ICBA remains concerned that Basel II may place community banks at a competitive disadvantage.

- ICBA is also concerned about the costs and complexity of Basel II and the ability of Basel II adopters to understand and implement the new accord. ICBA supports allowing the Basel II banks the option of using the "standardized approach" in lieu of the advanced approach.

- ICBA fully supports the current effort by the regulators to revise Basel I to enhance its risk-sensitivity and to address any competitive issues with a bifurcated framework; provided that the new rules give highly capitalized community banks the option to continue using the existing risk-based capital rules.

- During 2008—the year of the parallel run (when both Basel I and II capital will be calculated)--ICBA strongly recommends that the agencies conduct a fifth quantitative impact study to determine the impact that a revised Basel I would have on minimum risk-based capital and whether the competitive disparities between the Basel I and Basel II accords would be mitigated by a Basel IA. If QIS5 indicates that there continues to be a competitive disparity between Basel II and Basel IA, then the three year transition period should be put on hold until the regulators fundamentally revise Basel II.

ICBA Strongly Supports Retention of the Leverage Capital Ratio
As proposed by the agencies last week, the Basel II banks will remain subject to the tier 1 leverage ratio (e.g., tier 1 capital to total assets) and the prompt corrective action regulations mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). **ICBA commends the banking agencies for proposing to retain the tier 1 leverage ratio as part of the Basel II. ICBA strongly believes that retention of the leverage ratio is essential to maintaining the safety and soundness of our banking system and is a needed complement to the risk-sensitive Basel II framework that is based only on internal bank inputs.** Capital requirements under Basel II depend heavily on the answers to questions that vary from bank to bank and have no objectively best answer. No matter how refined a risk-based capital framework the regulators come up with, there will always be a need for straightforward capital minimums.

Furthermore, it is very important to our economy that regulators maintain a minimum capital cushion for our largest financial institutions that pose the greatest risks to our financial system. If a trillion dollar financial institution were to become significantly undercapitalized or fail, the consequences to the FDIC's Deposit Insurance Fund and our economy would be enormous. As then

Comptroller of the Currency John Hawke said before the Senate Banking Committee, "Reducing the leverage ratio would undermine our whole system of prompt corrective action which is the foundation stone of our system of supervision... I think we need to reach an appropriate accommodation where we try to make our basic system of regulatory capital rules more risk-sensitive, but we shouldn't do that at the price of dismantling or significantly impairing the basis for our supervision of U.S. banks."[6]

ICBA Supports the Transitional Capital Floors
Beginning in 2008, the Basel II banks will be able to conduct a parallel run--calculating their capital using both the present risk-based capital rules of Basel I and the advanced approaches of Basel II. During a three-year transition period from 2009 to 2011, Basel II banks would be subject to "transitional floors" that would limit the reduction of their minimum risk-based capital requirement in any year to 5%. **ICBA commends the banking agencies for proposing to adopt these transitional floors as well as committing to significantly modifying the supervisory risk functions of Basel II if, during the three-year transition period, there is a ten percent or greater decline in aggregate minimum risk-based capital of Basel II banks as compared to minimum required risk-based capital as determined under the existing Basel I rules.** We believe that any change 10% or greater would warrant a fundamental change to the Basel II rules.

ICBA Remains Concerned about the Competitive Inequities
Despite the safeguards incorporated into Basel II mentioned above and the efforts by the regulators to revise Basel I, ICBA remains concerned that Basel II may place community banks at a competitive disadvantage. The IRB approach of Basel II will yield lower capital charges for residential mortgage, retail and small business loans for Basel II adopters, the very credits where community banks compete with large institutions. An individual loan has the same risk to an institution whether a community bank makes the loan or a mega-bank makes it. It is not appropriate for the risk-based capital charge attendant to that loan to be widely divergent depending on whether the loan is made by a Basel I or a Basel II bank.

The results of both the third and fourth Quantitative Impact Studies (QIS3 and QIS4) have confirmed our concerns about the competitive equities of the new accord. These studies show dramatic reductions in capital for residential mortgage credits, small business credits and consumer credit. For instance, QIS4 indicates that for the Basel II banks, there would be a 79% median percentage drop in minimum required capital for home equity loans, a 73% drop for residential mortgage loans, and a 27% drop for small business loans. For all credits, risk-based capital requirements would decline by more than 26%. If one considers that the current minimum capital requirement under Basel I for mortgage loans is 4%, an average drop of 79% would mean that minimum capital

[6] Testimony before the Senate Banking Committee (April 20, 2004)

requirements for the Basel II banks would be less than 1% for these types of loans.

Since there is a cost to a bank for maintaining capital, the lower capital requirements would most likely result in a cost advantage, and correspondingly a pricing advantage, in retail credits for large banks that are subject to Basel II. The lower capital requirements will also make it easier for the Basel II banks to achieve a higher return on equity (ROE). **In order to compete with the cost advantage and the higher ROEs of Basel II banks, community banks may be forced to make concessions in pricing and underwriting guidelines that could impair their profitability, and ultimately their viability.**

ICBA also fears that Basel II will further accelerate the consolidation in the banking industry. Lower capital levels that large banks obtain under Basel II will likely result in more acquisitions of smaller banks by larger banks seeking to lever capital efficiencies. As more of the larger banks opt-in over the long-term, this may eventually threaten the viability of community banking. Since most community banks will remain under Basel I, they will have difficulty competing against bigger Basel II banks that benefit from reduced capital requirements and higher returns on equity. Basel I banks will become likely takeover targets for Basel II banks that believe they can deploy Basel I bank capital more efficiently. As more Basel I banks are left with riskier assets, lower credit ratings and higher costs of liabilities, they will find it more difficult to compete for the higher quality assets.

A paper released last year by J.P. Morgan Securities Ltd London entitled "Basel II—And the Big Shall Get Bigger" concludes that if Basel II were to be adopted in its present form, the Basel II banks would have a "decisive competitive advantage" over other banks and will look to expand and arbitrage their capital by purchasing smaller, less sophisticated banks. As for the effect of Basel II on community banks, J.P. Morgan says:

> It is difficult to see the future for the smaller community banks in this 'brave, new world'. This has not gone unnoticed as the S&P notes "U.S. community bankers are up in arms against Basel II, saying it gives an unfair advantage in leverage and pricing to large internationally active competitors over smaller domestic banking groups". This seems to be backed up by available information, from which it would appear that the large US and European banks are much more advanced in terms of implementing Basel II as well as likely to be big new beneficiaries of the process. We believe the best opportunities for smaller banks to combat this is perhaps through more cooperation with each other, to share data, bear costs and even swap assets. An alternative seems to be buying the risks that the bigger players do not want, which may mean the potential of adverse selection in credit risks. In our opinion, this is not a recipe for long-term success."

Community banks play not only a strong role in consumer financing in this country but also a critical role in small business financing. Commercial banks are the leading suppliers of credit to small business, and community banks account for a disproportionate share of total bank lending to small business. Community banks account for 33 percent of small business loans, more than twice their share (15%) of banking assets. **Because of the important role small businesses play in the economy (more than half the private sector workforce and two-thirds to three-quarters of new jobs), it is imperative to consider the competitive impact Basel II will have on community banks and their small business customers.**

Basel II is Too Complex and Costly

ICBA has always been concerned about the complexity of Basel II and the ability of Basel II adopters to understand and implement the new accord as well as the consequences if a mistake is made. The wide diversity in the results from QIS4 suggests that Basel II is too complex and that banks will have difficulty in applying the new accord consistently. Capital requirements in Basel II are very sensitive to inputs. Achieving consistency in Basel II depends on the idea that every bank will eventually adopt a common method for estimating their risk inputs leading to a convergence in the capital treatment of similar loan portfolios across banks. However, at least as indicated by the results of QIS4, there seems to be little commonality in the approaches that various banks used to estimate their risk inputs.

ICBA is also concerned about the high compliance and supervisory costs of Basel II. For example, nineteen of the twenty-six banks that participated in QIS4 indicated that it would cost $791 million over the next several years to implement the new accord. This estimate did not include the implicit costs of Basel II—the increased time and attention required of bank management to introduce and monitor the new programs and procedures. The OCC has estimated that its total 2005 costs for Basel II amounted to $7.1 million. Assuming that supervisory costs will increase during the Basel II transition period and that the other three banking agencies will incur comparable costs, it is easy to see that total supervisory and compliance costs for Basel II during the transition period will exceed $1 billion.

ICBA has recommended that the bank regulators consider ways of simplifying Basel II to reduce total compliance and supervisory costs and to insure that banks will understand the formulas and apply them consistently. The new accord and its capital formulas should not be so complex that banks cannot consistently apply the formulas and come to similar conclusions. Regulators should be able to readily spot intentional or unintentional errors or omissions in the formulas that are used. Basel II should also be simple enough that bank directors can monitor its implementation and auditors can certify to them as part of their internal control audits.

To reduce the costs and complexity of Basel II and enhance its flexibility, ICBA supports allowing the Basel II banks the option of using the "standardized approach" of the new accord in lieu of the advanced IRB approach. The standardized approach would provide a simpler and cheaper alternative for measuring credit risks and would be attractive option for smaller, less complex Basel II banks. The standardized approach would require fixed risk-weights to be applied to different assets much like Basel IA and would align risk weights with a borrower's creditworthiness as indicated by the borrower's external credit rating. Unlike Basel IA, banks using the standardized approach would have to assess operational risks. ICBA believes that the use of the standardized approach by the Basel II banks would reduce the impact on risk-based capital by those banks and would mitigate to some extent, the competitive disparity between Basel I and II.

ICBA Fully Supports a Basel IA

ICBA fully supports the current effort by the regulators to revise Basel I to enhance its risk-sensitivity for non-Basel II banks and to address any competitive issues with a bifurcated framework; provided that the new rules give highly capitalized community banks the option to continue using the existing risk-based capital rules. ICBA commends the issuance late last year of an Advance Notice of Proposed Rulemaking concerning a revised Basel I (ANPR) and looks forward to commenting on a notice of proposed rulemaking regarding a revised Basel I which is expected to be issued in the next few weeks.

ICBA supported the ANPR's proposal to add risk categories to Basel I to enhance its risk-sensitivity and to align capital requirements with risk levels. The risk-weightings of these categories should be modernized to better match current knowledge about actual risk exposures. More specifically, ICBA supported the proposal in the ANPR to add additional risk weights (e.g., a 20 percent and 35 percent category) for assessing a bank's one-to-four family mortgage portfolio and to base those risk weights on loan-to-value ratios. If risk-weights are based on LTV ratios, we would recommend that a mortgage loan LTV ratio be determined at the time the mortgage is originated and that banking institutions have the flexibility of changing or updating the risk weights of their mortgage loans as normal principal payments are made and/or as the LTV ratios change. While we acknowledge that pairing credit scores with LTV ratios might enhance the risk sensitivity of the mortgage loan risk weight categories, we believe the regulatory burden of including credit scores with LTV ratios outweigh the benefits.

For small business loans, ICBA recommends that the agencies establish a 75 percent risk weight category for small business loans that are under $2 million and that are (1) fully collateralized, (2) amortizable over a period of 10 years or less, and (3) have been originated consistent with the banking organization's underwriting policies. ICBA also agrees with the concept of using external credit ratings to enhance the risk-sensitivity of Basel I and supports the use of different risk weight categories for categorizing rated investment securities. ICBA agrees with the agencies that the current zero percent risk weight for short- and long-

term U.S. government and agency exposures that are backed by the full faith and credit of the U.S. government should be retained as well as the 20 percent risk weight for U.S. government-sponsored entities and for general obligation municipal securities.

ICBA Strongly Supports a Basel IA Opt-Out Provision for Community Banks

ICBA has urged the regulators to adopt an "opt-out provision" as part of a revised Basel I that would give highly capitalized community banks the option to continue using the existing risk-based capital rules and avoid the regulatory burden of more complex risk-based capital rules. Many community banks have excess capital and would prefer to remain under the existing risk-based capital framework without revision to avoid unnecessary regulatory burden. This is particularly true for smaller banks that are management-owned, otherwise closely held, or not publicly traded, or banks in rural or other smaller markets. These banks generally hold higher amounts of capital than regulatory minimums—many significantly higher—for a variety of reasons including a conservative philosophy or lack of ready access to raise capital in the capital markets. For instance, the average total risk-based capital ratio for banks under $100 million in assets is 19.7% and for banks between $100 million and $1 billion is 14.55% according the FDIC's latest Quarterly Bank Profile.

For highly capitalized banks, computing risk-based capital minimums and ratios using the contemplated Basel IA could present a significant regulatory burden with no corresponding benefit. This is particularly true since the agencies expect that if Basel IA is adopted, changes in reported Call Report data will be necessary in order to capture the additional information for LTV ratios and other risk driver data points such as collateral, loan size, term to maturity, etc. We recommend that the opt-out provision be limited to community banks with under $5 billion in assets that have capital-to-asset leverage ratios of 7 percent or higher.

ICBA Recommends a QIS5

During 2008—the year of the parallel run--ICBA also strongly recommends that the agencies conduct a fifth quantitative impact study to determine the impact that a revised Basel I would have on minimum risk-based capital and whether the competitive disparities between the Basel I and Basel II accords would be mitigated by a Basel IA. We believe that a one-year period should provide sufficient time for the agencies to collect the data, compare the two accords, and determine the competitive effects. If, by the end of 2008, the results of QIS5 indicate that there continues to be a competitive disparity between Basel IA and Basel II, then the three-year transition period should be put on hold until the regulators determine how to fundamentally revise Basel II.

Conclusion

The ICBA again appreciates the opportunity to present our views on the proposed commercial real estate guidance and proposed international capital standards. We believe that the CRE guidance is seriously flawed and could undermine community banks' ability to serve their growing communities. Rather than imposing a one-size-fits-all approach, the agencies should use existing policies and procedures to ensure that, on a bank-by-bank basis, risks from all types of lending – including commercial real estate – remains at acceptable levels.

ICBA remains concerned that Basel II may place community banks at a competitive disadvantage. Improvements to Basel I, a Basel IA, could help mitigate that disadvantage. As it implements these proposals, the agencies should conduct a fifth quantitative impact statement to measure their effect on competition and on minimum risk-based capital levels. If, by the end of 2008, the results of a fifth quantitative impact statement indicate that there continues to be a competitive disparity between Basel IA and Basel II, the three-year Basel II transition period should be put on hold until the regulators determine how to fundamentally revise Basel II.

Attachment:

TERRY J. JORDE
Chairman
JAMES P. GHIGLIERI, JR.
Chairman-Elect
CYNTHIA BLANKENSHIP
Vice Chairman
KEN PARSONS, SR.
Treasurer
ROBERT C. FRICKE
Secretary
DAVID E. HAYES
Immediate Past Chairman

CAMDEN R. FINE
President and CEO

June 23, 2006

Honorable Susan Schmidt Bies
Board of Governors of the Federal Reserve System
20th and Constitution Avenue, NW
Washington, DC 20551

Honorable John C. Dugan
Comptroller of the Currency
205 E Street, SW
Washington, DC 20219

Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, Room 6000
Washington, DC 20429

Honorable John M. Reich
Director
Office of Thrift Supervision
1700 G Street, NW, 5th Floor
Washington, DC 20552

Dear Sirs and Madam:

A recent article (attached) raises a very serious concern about the pending interagency guidance on commercial real estate lending. The article treats the proposed thresholds as new buy/sell indicators for investment transactions, regardless of a bank's other business or financial indicators. We are extremely troubled by the application of the proposed guidance in this manner.

The article's author, Richard Suttmeier, president of Global Market Consultants, Ltd. and chief market strategist for Joseph Stevens & Co, applies the proposed concentration thresholds to several banks and recommends adding to or reducing positions in their stock, based only on price targets and on their percentage of CRE loans to capital. The largest banks fare well in this analysis because their huge size means lower ratios of CRE loans to capital. For example, he recommends that investors buy Bank of America stock

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because its ratio is "a mere 29%, below the FDIC 100% threshold" whereas he recommends immediately reducing holdings of the much smaller BB&T Bank because its CRE loans are "way above the FDIC's red line at 197%" for one threshold and "above danger levels at 364%" for the second threshold.

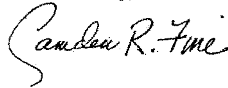
This type of analysis shows that the CRE proposal heavily discriminates against smaller institutions. The proposal will have little effect on the largest banks. In fact, following this analysis, the proposal favors the largest banks, and is a reason to increase holdings in their stock. By contrast, smaller banks and community banks will be negatively affected. This analyst sees the proposed concentration thresholds as absolute cutoff levels, stating that when a bank's commercial development loans exceed 100% of capital, "it's a warning." When CRE loans exceed 300%, "it's a danger sign."

In our April 12, 2006 comment letter, ICBA strongly urged the banking agencies not to go forward with the proposed CRE guidance, and expressed our great concern that the proposal is overly broad, defining concentrations of risk in a manner that cannot assess the true risk in a bank's CRE lending and that disproportionately affects community banks. We reiterate that position.

The proposed thresholds cannot capture true risk because they do not take into account underwriting standards and risk management practices. The thresholds treat all CRE loans as having equal risk. Mr. Suttmeier did not take into account the quality of underwriting standards and risk management practices or risk levels of individual loans when making his "add to holdings" or "reduce holdings" recommendations. Thus, the use of the proposed thresholds does not give a true picture of the risk in a financial institution's portfolio but rather, in this case, misleads the investing public.

The guidance has great potential to precipitate a credit crunch among smaller banks and community banks and severely hamper their ability to provide CRE credit in thousands of cities and towns across America. Again, ICBA urges the banking agencies not to go forward with the guidance as proposed.

Sincerely,



Camden R. Fine
President and CEO

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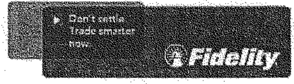

Active Trader Update

A Landslide Could Bring Down Banks

By Richard Suttmeier

RealMoney.com Contributor

6/14/2006 3:00 PM EDT

URL: http://www.thestreet.com/markets/activetraderupdate/10291754.html

This column was originally published on RealMoney *on June 14 at 1:00 p.m. EDT. It's being republished as a bonus for* TheStreet.com *readers.*

While the massive size and diversification of the biggest U.S. banks have kept their Federal Deposit Insurance Corporation (FDIC) ratios well below red lines indicating overexposure to real estate, the extent of their underwriting in construction lending and multifamily and commercial real estate lending is a matter of concern. If the **Federal Reserve** continues to raise rates, defaults on these types of loans will put a damper on future profits of all the financial institutions participating in what has been a major boom.

The selloff in stocks hasn't affected the finance sector as much as the rest of the market, partially due to the expectation that the Federal Reserve will soon stop raising rates. The finance sector is currently the most overvalued, but by just 3.5%.

It appears that the FOMC is hell-bent to raise the federal funds rate to 5.25% at its next meeting at the end of June. I believe additional rate hikes will increase the probability that defaults on real estate loans will rise.

The top six banks by total assets and Tier 1 capital are **Bank of America** (BAC:NYSE) , **JPMorgan** (JPM:NYSE) , **Citibank** (C: NYSE) , **Wachovia Bank** (WB:NYSE) , **Wells Fargo** (WFC:NYSE) and **Washington Mutual** (WM:NYSE) .

Bank of America has the most exposure to construction loans, followed by Wachovia and Wells Fargo and the smaller banks **SunTrust** (STI:NYSE) and **Branch Banking & Trust** (BBT:NYSE) .

All of the financial institutions in the table below are rated hold by ValuEngine, except for JPMorgan. Only JPMorgan and Wachovia are trading slightly below fair value. The weekly chart profiles are mixed. What's interesting is that BB&T and SunTrust, the stocks that are most exposed to real estate, have positive profiles.

Financial Institutions

	June 13 Price	Rating	(-UV) / OV%	Fair Value	MOM	5-Week MMA	Value Levels	Pivots	Risky Levels
Bank of America	$47.07	HOLD	1.90%	$46.20	DM	$48.50	46.07 A / 44.12 A	48.49 M / 49.59 Q	51.95 S / 54.44 S
BB&T Bank	$42.23	HOLD	6.50%	$39.66	RM	$41.98	40.08 S / 39.85 Q	41.24 M / 41.96 S	52.88 A
Citigroup	$48.21	HOLD	2.80%	$46.89	DM	$49.21	45.44 Q	51.30 M	61.32 A

JP Morgan	$40.53	BUY	-6.80%	$43.49	DM	$43.14	39.85 Q	43.04 M / 43.51 A	49.50 A
SunTrust	$76.39	HOLD	2.80%	$74.31	RM	$76.22	72.83 M / 70.33 Q		87.96 A
Wachovia	$53.04	HOLD	-4.20%	$55.34	DM	$55.19		52.98 Q / 55.89 M	57.84 A
Wells Fargo	$67.07	HOLD	9.00%	$61.56	RM	$67.20	64.30 M / 63.23 S	69.82 A	70.50 S
Washington Mutual	$44.13	HOLD	13.10%	$39.03	RM	$45.15	42.19 M / 41.59 A		47.34 A / 47.67 S

Key: OB, overbought; DM, declining momentum; RM, rising momentum; OS, oversold; M, monthly; Q, quarterly; S, semiannual; A, annual. A value level is a price at which my models project that buyers will emerge; a risky level is a price at which investors are likely to reduce holdings, according to my models. A pivot is a value or risky level that has been breached in its particular time horizon; the stock will likely trade around this pivot.
Source: Global Market Consultants

The FDIC compiles two ratios for financial institutions based on quarterly reporting of their underwriting activities in construction lending and lending for multifamily properties and commercial real estate:

- The CD loans ratio measures construction lending vs. Tier 1 capital. When this ratio exceeds 100%, it's a warning.
- The CRE loans ratio measures the total of construction, multifamily and commercial real estate lending vs. Tier 1 capital. When this ratio exceeds 300%, it's a danger sign.

Bank of America has the largest exposure to construction loans of any financial institution at $20.7 billion, but given its tremendous level of assets, its CD ratio is a mere 29%, below the FDIC 100% threshold. With this balance, investors should add to holdings on weakness to my annual value levels of $46.07 and $44.12 and reduce holdings at my semiannual risky levels of $51.95 and $54.44.

The much smaller BB&T Bank is fifth in the size of its exposure to construction loans at $11 billion, putting its CD ratio way above the FDIC's red line at 197%. Its CRE ratio is also above danger levels at 364%. The stock isn't much below its 52-week high at $43.90. Investors should reduce holdings now, with shares between my monthly and semiannual pivots of $41.24 and $41.96.

Citigroup's exposure to CD loans is only 1% of capital and isn't a major concern for investors. Add to positions on weakness to my quarterly value level of $45.44 and reduce holdings if it rises to my monthly pivot of $51.30.

JPMorgan's exposure to CD loans is only 10% of capital, and it was upgraded to buy Wednesday morning by ValuEngine. With shares trading around my quarterly value level of $39.85, I'd increase my stake now. If it rises to my annual risky level of $49.50, I'd reduce holdings.

SunTrust has the fourth-largest construction-loan portfolio at $12.1 billion, putting its CD ratio at 101%, just over the FDIC guideline. With the stock recently pushing at its 52-week high of $78.33, investors should reduce holdings now, or on a weekly close below the five-week MMA of $76.22.

Wachovia has a manageable CD ratio of 57%. Investors should add to holdings if it falls to my quarterly value level of $52.98 and pare back positions if it rises to my annual risky level of $57.84.

Wells Fargo has a manageable CD ratio of 55%. Investors should add to positions on weakness to my monthly and annual value levels of $64.30 and $63.23 and reduce holdings on strength to my semiannual risky level of $70.50.

Washington Mutual's exposure to CD loans is only 13% of capital. I'd buy more if it drops to my monthly and annual value levels of $42.19 and $41.59 and reduce holdings on strength to my annual and semiannual risky levels of $47.34 and $47.67.

If you have a bank you wish me to profile, send me an email.

P.S. from TheStreet.com Editor-in-Chief, Dave Morrow:
It's always been my opinion that it pays to have more -- not fewer -- expert market views and analyses when you're making investing or trading decisions. That's why I recommend you take advantage of our free trial offer to TheStreet.com's *RealMoney* premium Web site, where you'll get in-depth commentary *and* money-making strategies from over 50 Wall Street pros, including Jim Cramer. Take my advice -- try it now.

Richard Suttmeier is president of Global Market Consultants, Ltd., and chief market strategist for Joseph Stevens & co., a full service brokerage firm located in lower Manhattan. Early in his career, Suttmeier became the first U.S. Treasury Bond Trader at Bache. He later began the government bond division at L. F. Rothschild. Suttmeier went on to form Global Market Consultants as an independent third-party research provider, producing reports covering the technicals of the U.S. capital markets. He also has been U.S. Treasury Strategist for Smith Barney and chief financial strategist for William R. Hough. Suttmeier holds a bachelor's degree from the Georgia Institute of Technology and a master's degree from Polytechnic University.

Testimony of

America's Community Bankers

on

"A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate"

before the

Subcommittee on
Financial Institutions and Consumer Credit

of the

Committee on Financial Services

of the

United States House of Representatives

on

September 14, 2006

F. Weller Meyer
Chairman, President and CEO
Acacia Federal Savings Bank
Falls Church, Virginia

and

Chairman
Board of Directors
America's Community Bankers
Washington, DC

Chairman Oxley, Ranking Member Frank, Subcommittee Chairman Bachus, and members of the Committee, I am Weller Meyer, Chairman, President & CEO of Acacia Federal Savings Bank in Falls Church, Virginia. Acacia Federal has more than $1.3 billion in assets and is a member of the UNIFI Group of companies, which are a diversified group of insurance and financial services businesses.

I am submitting this statement on behalf of America's Community Bankers (ACB) of which I am Chairman of the Board of Directors. I want to thank Chairman Oxley for calling this hearing on the Basel II and Basel IA proposals and on the Interagency Commercial Real Estate (CRE) Guidance proposal. The outcomes of these proposals are critically important to ACB member institutions. The first part of my remarks will focus on the Basel proposals and I will follow with a discussion of the CRE Guidance.

Overview of Basel II and Basel IA

ACB and its members took the early lead on the proposed regulatory capital changes affecting banks and savings associations. We believe that the development and implementation of Basel II and Basel IA are critically important regulatory initiatives for financial institutions today. We support the adoption by U.S. and international bank supervisors of a risk-based capital system that more finely tunes the amount of capital an institution holds to the risk taken by that institution. However, ACB remains concerned about the possible competitive impact Basel II will have on community banks when it is implemented in the United States. Furthermore, ACB is concerned that the complexity of implementing Basel II will place the large, internationally active U.S. banks at a competitive disadvantage vis-à-vis foreign banks that have been given a choice between the internal models version of Basel II and a more standardized approach.

Since the Basel Accord was first adopted in 1988, financial institutions have developed sophisticated tools to more accurately measure credit, interest rate, operations, market, and other risks. We believe that now is an appropriate time to review the current capital requirements that apply to all financial institutions and revise them to reflect changes in risk management that have occurred over the last decade.

In the United States, the federal banking agencies (Agencies) are working to update the Basel framework and create for the first time a bifurcated regulatory capital system. As currently contemplated, only about 10 financial institutions in the United States would be required to comply with Basel II. An additional 10 to 15 believe that they have the resources to voluntarily comply or opt-in. All other banks and savings associations would remain subject to Basel I or possibly as amended, Basel IA.

We commend the efforts of the Agencies to develop a Basel II proposal that is workable for the largest, internationally active U.S. banks. However, we strongly believe that Basel II should not be implemented unless changes are made to Basel I to more closely align capital with risk for other depository institutions. Otherwise, we believe that Basel I banks would be left at a serious competitive disadvantage and would become possible

acquisition targets for Basel II banks. Finally, ACB strongly recommends that small community banks continue to have the option to comply with Basel I in its current form.

We understand that the banking regulators expect to issue a Basel IA proposal in the near future. We also understand that the Agencies plan to substantially overlap the public comment periods for the Basel II and Basel IA proposals and that the proposals are expected to be finalized at the same time, allowing for the consideration of the overall capital framework for all banks. It is clear that the Agencies are listening to the industry's perspectives on Basel issues that affect an institution's capital requirements and business strategy. It is our hope that Basel II and Basel IA will be risk sensitive without adding significant new regulatory burden.

Basel II Accord

Early in the process of developing a Basel II proposal, the Agencies determined that U.S. Basel II banks would use the "Advanced Approach," which would require each bank subject to Basel II to develop its own credit risk and operational risk models to determine capital levels. In contrast, banks in other industrialized countries are allowed by their regulators to choose between the methods described in the international Basel II Accord in order to determine capital requirements, including the "Standardized Approach". The Standardized Approach is simpler than the Advanced Approach.

In 2003, the Agencies requested public comment only on the Advanced Approach for determining capital levels. We are uncertain as to why the Agencies did not consider use of the Standardized Approach for U.S. Basel II banks.

We strongly believe that banks must have the opportunity to choose the capital calculation that best suits their business needs and risk profile and that Basel II banks be able to choose between the Standardized Approach or the Advanced Approach. The flexibility to adopt the Standardized Approach will help U.S. banks to compete both domestically and internationally with foreign banks that already are preparing to comply with Basel II.

ACB has significant concerns about the complexity of the Basel II proposal and the ability of financial institutions to bear the significant costs of accurate implementation of the proposal. We are also concerned with the capacity of the Agencies to adequately administer and enforce the new capital requirements without significant new reporting requirements. Furthermore, we are under the impression that there will be a substantial recordkeeping and reporting burden for institutions that would be subject to Basel II. We believe this is another reason that banks should be able to adopt the Standardized Approach for calculating capital. In addition to simplifying capital calculations, the Standardized Approach would allow banks to manage their reporting burden as well.

We are pleased that, last week, the FDIC board voted to seek public comment on whether Basel II banks should be permitted to choose between multiple methods for calculating capital requirements.

In summary, ACB believes that prior to the final adoption of Basel II, the regulators and the industry need to evaluate the complexity of the proposal and the ability to monitor compliance. This would include greater consideration of the real-world consequences of adopting an extremely complicated capital regime, the resources needed for implementation, the problems inherent in on-going maintenance, the likelihood of effective regulation and market oversight, and the competitive pressures that could potentially encourage banks to "game" the system.

Competitive Concerns for Community Banks

Unfortunately, the complexity and costs associated with developing and implementing the models needed to measure and evaluate risk likely will preclude all but a small number of banks in the United States from opting into the more risk sensitive capital regime proposed in Basel II.

The best available evidence suggests that Basel II will open the door to competitive inequities between large banks and community banks. The quantitative impact study, QIS-4, conducted by the Agencies showed that the Basel II Accord would result in significant capital savings for some of the largest banks in the United States and other countries. These large institutions compete head-to-head domestically with community banks in the retail area. Retail lending, particularly residential mortgage lending, is a fundamental business of community banks.

Under this bifurcated system, two different banks, a larger Basel II bank and a small Basel I community bank, could review the same mortgage loan application that presents the same level of credit risk. However, the larger bank would have to hold significantly less capital than the small bank if it makes that loan, even though the loan would be no more or less risky than if the community bank made the loan. Because capital requirements play a part in the pricing of loan products, the community bank may not be able to offer the same competitive rate offered by the larger institution. This result is not acceptable. Capital requirements should be a function of risk taken, and if two banks have very similar loans, they should have a similar required capital charge.

In addition, we are concerned that unless Basel I is appropriately revised, smaller institutions under a bifurcated capital regime will become takeover targets for institutions that can utilize capital more efficiently under Basel II. For instance, if a large bank could acquire a community bank's assets at a fraction of the required capital ratio imposed on the large bank, they would surely do so. The required capital at the acquired bank now would be excess capital under a Basel II structure. The bifurcated capital structure would drive acquisitions that otherwise would have no economic purpose.

Community banks must be permitted to utilize their capital effectively and judicially while improving their ability to manage risk. Therefore, community banks must be given the choice to opt-in to the Basel II Standardized Approach, comply with a revised and

more risk-sensitive Basel IA, or continue to comply with the current Basel I framework if it better suits the institution's business needs and risk profile.

In short, the same capital options available to larger institutions must be available to smaller institutions and vice versa.

Creation of Basel IA

In October of last year, the Agencies issued an Advance Notice of Proposed Rulemaking (ANPR) regarding possible changes to the capital framework to create Basel IA. ACB made many suggestions and observations in the comment letter we filed with the Agencies (See Appendix A). We look forward to studying and commenting on the Basel IA Notice of Proposed Rulemaking (NPR) that is expected to be published for public comment in the near future.

ACB has advocated in its letters to the Agencies and in previous testimony before Congress that the current Basel I capital regime be amended to take advantage of the ability of institutions and supervisors to measure risk more accurately.

Basel I fails to consider such risk factors as the loan-to-value ratio of retained mortgage portfolios, collateralization of commercial loans, and banks' significant nonfinancial assets. For example, a mortgage loan with a 20 percent loan-to-value ratio is risk weighted the same as a mortgage loan with a 90 percent loan-to-value ratio. However, the risks associated with these loans are not the same. These are examples of elements of risk measurement that will be available to the banks that comply with Basel II, while the vast majority of U.S. banks will have to comply with the outdated risk measurement, unless Basel I is amended.

As proposed in the ANPR, a revised Basel IA would include more risk buckets and a breakdown of particular assets into multiple baskets to take into consideration collateral values, loan-to-value ratios, and credit scores. Credit risk mitigation measures, such as mortgage insurance and guarantees, would be incorporated into the framework. Other revisions would be made to further refine current capital requirements. Such an approach would be relatively simple for banks to implement and for regulators to supervise. A Basel IA approach is also very similar to the Standardized Approach and could allow the Agencies to move to adoption of a Standardized Approach in Basel II over the next several years.

We also believe that small community banks should have the option of continuing to comply with Basel I in its current form. We encourage the Agencies to allow institutions the flexibility to choose a model that best works for that institution. There are many smaller institutions that hold capital well in excess of minimum requirements and will continue to do so after Basel IA or Basel II is implemented. These institutions often operate in small communities, may be mutually owned, family owned, or privately held. These institutions believe that higher capital is appropriate to their ownership structure. Institutions should not have to comply with the increased regulatory burden of changed

capital requirements if they would prefer to remain compliant with a more straightforward, but a less risk-sensitive Basel I.

Leverage Ratio

We understand that the Agencies intend to leave a leverage requirement in place. We support the maintenance of a leverage ratio for all financial institutions and believe that a regulatory capital floor is necessary to mitigate the imprecision inherent in internal ratings-based systems. The results of QIS-4 raised significant concerns over the implementation of Basel II and the potential for a significant reduction of risk-based capital. That study was conducted with a group of U.S. institutions that are expected to adopt Basel II and showed evidence of large reductions in the aggregate minimum required capital. Because of this study, in the Basel II proposal the Agencies agreed to a minimum aggregate decline of 10 percent per year and a leverage ratio floor of 5 percent.

In 1991, Congress enacted FDICIA, which set out a requirement for a leverage ratio component in capital for U.S. financial institutions. Congress specifically set the "critically undercapitalized" level at 2 percent. While Congress left the other ratios to agency discretion, it is appropriate for Congress to oversee the implementation of a requirement it created. ACB suggests that the precise level of the leverage requirement should be open for discussion. Institutions that comply with Basel II, and institutions that comply with a more risk-sensitive Basel IA, may not achieve the full benefits of more risk-sensitive capital requirements if the current minimum leverage ratio remains unchanged. Absent changes to the current leverage ratio, institutions may make balance sheet adjustments based solely on capital requirements rather than on the best interests of the business.

In addition, ACB suggests that foreign bank supervisors should also consider adopting a leverage ratio as a means of protecting their financial systems. This would be an important improvement in the original Basel Accord.

Proposed Interagency Commercial Real Estate Guidance (CRE Guidance)

We commend this Committee for combining the subjects of Basel and CRE in this hearing. Commercial real estate is vitally important to the lending programs of many community bankers, to the revitalization of urban communities and to the strength of the American economy. We understand that the Agencies may be concerned that some financial institutions may have high and increasing concentrations of commercial real estate loans on their balance sheets that may make these institutions more vulnerable to cyclical commercial real estate markets. Recent financial data also suggest a decline in credit quality in some portfolios.

ACB agrees with the Agencies that strong underwriting standards must be maintained. However, we do not believe the proposed CRE guidance appropriately addresses the concerns that the Agencies may have about increasing concentrations and declining credit

quality in the CRE lending area. The guidance, as proposed, establishes a "one size fits all" approach through rigid threshold tests for determining CRE concentrations and establishes discretion to require an increase in capital outside of the Agencies' capital regulations. We believe that any final guidance should balance the Agencies' concerns with the unintended consequence of forcing some lenders out of the CRE market, creating an unnecessary and unintended shortage of credit. CRE lending should not be addressed, as some have suggested, by requiring banks to find an outlet to move the loans off balance sheet to a REIT or some other outlet.

The banking regulators already have complete authority to exercise oversight and enforce rules and regulations to address unsafe and unsound practices, including prompt corrective action and/or capital inadequacy for any individual institution. Therefore, we question the need for additional guidance and the imposition of rigid threshold tests.

We believe each institution should continue to be evaluated on a case-by-case basis as part of the ongoing safety and soundness examination. This evaluation should be based on the overall capital structure of the institution, delinquency trends and historical losses, composition of the CRE portfolio, performance of that portfolio and the quality of underwriting including classified loans, delinquency trends and losses, demographics of the market served and the level of management controls in place at each institution. ACB strongly believes that an institution's risk management practices should be appropriate for the size and complexity of the individual institution. To avoid unnecessary burden, the risk management examination for a small institution should not be the same as for a large, complex institution.

As our comment letter to the Agencies pointed out, the Proposed Guidance contains a definition of a CRE loan that is too broad (See Appendix B). It is not accurate to combine all types of CRE loans into a single risk classification for purposes of setting thresholds. Different types of commercial real estate have very different risk profiles. For example, it is important to differentiate speculative CRE loans for raw land, land development, contractor spec home construction, and commercial construction and development from non-speculative CRE loans that either have firm takeouts or established cash flow patterns.

While we do not believe hard concentration thresholds are necessary, at a minimum, any final guidance should correspond additional regulatory scrutiny to the actual risk inherent in the portfolio. ACB believes that multifamily loans, pre-sold residential construction and construction/permanent financing with either firm takeouts or established cash flows that provide sufficient debt service coverage should be excluded from the definition of CRE loans. This change will allow the Proposed Guidance to focus on those types of speculative loans that are most susceptible to economic downturns.

ACB also acknowledges that financial institutions engaged in CRE lending should be capitalized adequately and that the capital levels should be based on the inherent levels of risk being taken by the financial institution in their various loan portfolios. However, ACB has serious concerns about the manner in which the proposed guidance would tie

requirements for increased capital levels to concentrations of commercial real estate portfolios. We believe very firmly that any requirement for an institution to raise its capital above regulatory minimums should be imposed in the context of the Agencies' capital regulations as they exist now or as they are amended through the Basel process.

ACB's comment letter to the Agencies' on the Basel IA proposal specifically stated the following as it relates to CRE:

- The risk criteria that should be taken into account to differentiate multifamily residential mortgages should be LTV ratios and number of units. A similar approach to the buckets for single-family residential mortgage loans should be used to stratify these mortgages based on risk.

- We support the approach in the proposal that would provide lower risk weights for commercial real estate loans that meet certain conditions, such as compliance with appropriate underwriting standards and the presence of an appropriate amount of long-term borrower equity. In order to ensure that Basel I banks are not put at a competitive disadvantage with regard to Basel II banks for the treatment of commercial real estate, we believe institutions should be provided an option to risk-weight these loans in additional buckets using LTV ratios and loan terms as risk drivers.

- While we support the use of credit ratings as a factor in determining the risk of commercial loans, we also urge the Agencies to allow banks to use additional types of collateral and LTV ratios when no credit rating exists. Many community banks make both large and small commercial loans to borrowers that do not have a credit rating. We believe the permitted use of additional non-rated collateral LTVs will help keep capital requirements fairly simple, encourage lending to creditworthy and unrated businesses, and avoid any potential competitive disadvantages.

- We believe that any expansion of the types of eligible collateral or guarantees that can be used to mitigate risk should be optional for the institution. Institutions that want to keep capital requirements simple and do not want the added burden of continually tracking collateral should have that option.

Thus, we strongly oppose any requirement that an institution increase its capital levels based only on the fact that the institution may have a concentration of CRE loans as suggested in the proposed guidance.

Finally, we note that although four of the member agencies of the Federal Financial Institutions Examination Council (FFIEC) have proposed to issue CRE guidance, the National Credit Union Administration has not proposed similar limitations on credit unions. Credit unions are increasing their activity in CRE lending and are seeking more authority from Congress. We are puzzled as to why CRE guidance should not apply to credit unions engaging in the same activities as banks.

Conclusion

We wish to thank Chairman Oxley, Ranking Member Frank, Subcommittee Chairman Baucus and the rest of the Committee members in giving ACB this opportunity to present our views. As we mentioned at the outset, capital requirements for U.S. financial institutions are a critical component in the safe and sound functioning of the banking system as well as the ability of U.S. banks to compete against each other and foreign banks. ACB stands ready to support Congress and the Agencies in implementing capital standards that more closely align capital to risk for all institutions.

APPENDIX A

January 17, 2006

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail stop 1-5
Washington, DC 20219

Attention Docket No. 05-16
regs.comments@occ.treas.gov

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Attention: Docket No. R-1238
regs.comments@federalreserve.gov

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

comments@FDIC.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

Attention: No. 2005-40
regs.comments@ots.treas.gov

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications
70 FR 61068 (October 20, 2005)

Dear Mesdames and Sirs:

America's Community Bankers ("ACB")[1] is pleased to comment on the joint advance notice of proposed rulemaking ("ANPR") issued to solicit comments on changes to the risk-based capital framework for depository institutions in the United States.[2] The revised framework would apply to those banks and savings associations that are not required to comply with, nor are able to opt-in to, the revised Basel Capital Accord developed by the Basel Committee on Banking Supervision at the Bank for International

[1] America's Community Bankers is the member-driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit *www.AmericasCommunityBankers.com.*
[2] 70 Fed. Reg. 61068 (October 20, 2005).

Settlements ("Basel II"). This ANPR would lead to the issuance of a notice of proposed rulemaking at or near the time that the agencies also issue a notice of proposed rulemaking for Basel II.

ACB Position

We are pleased that the agencies have taken this step to revise risk-based capital requirements for all depository institutions. We believe that now is an appropriate time to review the current capital requirements that apply to everyone and revise them to reflect the changes in risk management and operations that have occurred over the last decade. Also, as we have made clear in our comment letters on the Basel II proposal and at Congressional hearings, we strongly believe that Basel II should not be implemented unless changes are made to Basel I for other depository institutions. Otherwise, we believe that Basel I banks would be left at a serious competitive disadvantage and also would become possible acquisition targets for Basel II banks.

You will note that our comments discussing different asset categories generally argue for more risk buckets and the ability of an institution to choose how much burden they wish to incur in exchange for more risk-sensitive capital requirements. We believe that more buckets provide greater ability to differentiate risk among loans in a certain asset category. However, we would encourage the agencies to allow institutions some flexibility in choosing a model that best fits their needs and matches their resources. For some institutions, the process of collecting, updating and reporting borrower and loan characteristics that are relevant barometers of risk will not be too burdensome. Other institutions may prefer simpler, more straightforward capital requirements, as are prescribed under existing Basel I standards.

The following is a summary of our position on the many questions contained in the ANPR, with more detail on each of these topics provided in the remainder of this comment letter.

- ACB strongly supports risk buckets based on loan-to-value ("LTV") ratios for one-to-four family residential mortgage loans. If other risk criteria, such as credit scores and debt-to-income ratios are to be included in a revised Basel I, they should be optional for those institutions that wish to incur additional burden in order to have capital requirements even more closely aligned with risk. We support the use of private mortgage insurance ("PMI") to reduce the numerator in the LTV ratio. There should not be different treatment for what the ANPR refers to as "non-traditional" mortgage products. We also provide an alternative approach to the proposed treatment of second lien mortgages.

- The risk criteria that should be taken into account to differentiate multifamily residential mortgages should be LTV ratios and number of units. A similar approach to the buckets for single-family residential mortgage loans should be used to stratify these mortgages based on risk.

- The collateral value for automobile and other secured consumer loans should be taken into account to differentiate these loans by LTV ratios. The agencies should consider allowing an option for banks to also use the loan term, credit scores and debt-to-income ratios for other types of unsecured retail loans to attain an even more accurately aligned risk weighting.

- We support the approach in the proposal that would provide lower risk weights for commercial real estate loans that meet certain conditions, such as compliance with appropriate underwriting standards and the presence of an appropriate amount of long-term borrower equity. In order to ensure that Basel I banks are not put at a competitive disadvantage with regard to Basel II banks for the treatment of commercial real estate, we believe institutions should be provided an option to risk-weight these loans in additional buckets using LTV ratios and loan terms as risk drivers.

- We believe that it is appropriate to provide a lower risk-weight for small business loans that have lower LTV ratios based on the value of eligible collateral, no defaults and full amortization over a seven-year period. Two or three buckets should be available to institutions that are willing to incur more burden, with loans slotted based on LTV ratios and loan term. An alternative could also be offered that would allow an institution to adjust the risk weighting based on the credit assessment of a shareholder guarantor. Small business loans should be defined as those loans under $2 million on a consolidated basis to a single borrower.

- While we support the use of credit ratings as a factor in determining the risk of commercial loans, we also urge the agencies to allow banks to use additional types of collateral and LTV ratios when no credit rating exists. Many community banks make both large and small commercial loans to borrowers that do not have a credit rating. We believe the permitted use of additional non-rated collateral LTVs will help keep capital requirements fairly simple, encourage lending to creditworthy and unrated businesses, and avoid any potential competitive disadvantages.

- We believe the substantial cliff effect that occurs for short-term commitments should be removed by applying a credit conversion factor of 20 percent to all commitments regardless of term. This should not apply, however, to commitments that are unconditionally cancelable at any time or that effectively provide for automatic cancellation. These commitments should have a zero credit conversion factor.

- We do not support an increase in risk weighting for past due loans. Current regulatory requirements provide that depository institutions set aside reserves and take other steps to mitigate the risk of these loans and their impact on the

institution. Also, an automatic upward adjustment without consideration of LTV ratios would not be appropriate.

- We believe that any expansion of the types of eligible collateral or guarantees that can be used to mitigate risk should be optional for the institution. Institutions that want to keep capital requirements simple and do not want the added burden of continually tracking collateral should have that option.

- We strongly believe that a leverage ratio should remain in effect.

- The agencies should consider developing, or encouraging third parties to develop, a simplified risk-modeling system that could be used by less complex banks to establish minimum capital requirements.

- Depository institutions of any size that would prefer to remain subject to Basel I as it currently exits should have the option to do so. Also, institutions should be provided flexibility to utilize some of the fundamental principles in a revised Basel Ia approach to gain a more risk-sensitive capital approach without undue burdens.

One-to-Four Family Residential Mortgage Lending

Risk-Weight Categories. The agencies are contemplating revising the 50 percent risk weighting for all mortgage loans that would adjust the risk weight based on LTV ratios. ACB strongly supports this approach. LTV ratios historically have been a strong indicator of risk, are readily available to community banks, and can be updated fairly easily even if on a quarterly basis. We believe that the numerator of the LTV ratio should be based on the net balance carried on the books of the institution to take into account any discount on purchased loans. Net balance reflects the true exposure of the institution.

With regard to updates of LTV ratios, we believe that the denominator should be based on the appraisal of the property obtained at the time of the loan closing. However, institutions should be given the option of updating the appraisals if they would like to undertake that burden to get capital requirements even more closely aligned with changing risk.

With regard to other loan characteristics that might reflect risk, our members have various opinions with regard to whether credit scores or debt-to-income levels would be more appropriate to put into a matrix with LTV ratios to determine risk. Most of our members believe that the LTV ratio is the best indicator of the risk of a mortgage loan and that credit scores or other ratios could be used in combination with LTV ratios, but should not be used in isolation. Credit scores and debt-to-income ratios provide valuable information and are appropriate indicators of a borrower's ability to repay a loan and, therefore, the risk level of the loan. We know of no study that shows which alternative,

credit scores or debt-to-income ratio, is a better indicator of risk, so a proposal could offer the opportunity to use one or the other or both in the matrix.

There is some concern that any requirement to update the information with regard to credit scores or debt-to-income levels would be too burdensome for many community banks. Therefore, we support an approach that would permit those institutions that wish to include these characteristics in their risk assessment be permitted to do so in accordance with any parameters established by the agencies. This gives institutions the greatest flexibility to choose the level of risk sensitivity that is appropriate to the amount of burden they wish to incur.

The ANPR references "non-traditional" mortgages and questions whether these loans should be treated in the same matrix as traditional mortgage products or whether they pose unique and greater risks that warrant higher capital charges. Our members strongly believe that all single-family residential mortgages should be treated the same under the capital framework. As an initial matter, it is unclear what products would be considered non-traditional mortgages in the current environment where the types of mortgage loans made in the past may not be the only ones appropriate in a more mobile society that manages finances and debt differently. Many of our members have several decades of experience with a whole range of mortgages, including adjustable rate and other alternative products, and this experience has occurred through times of significant economic stress. Any capital proposal should draw upon this actual experience when developing relevant risk weightings.

Our members feel that LTV ratios are the best indicator of risk for any single-family mortgage loan, notwithstanding the characteristics of the loan. Similarly, credit scores and debt-to-income ratios are calculated in the same way for all types of mortgage loans and are applied differently only in the sense that a higher or lower credit score or debt ratio may be required for different types of products.

PMI. The agencies have questioned whether there should be certain limits on the use of PMI to decrease the numerator in LTV ratios. We understand there could be some concern with the ability of PMI companies to honor commitments during a time of economic stress. Therefore, we support the approach that would recognize PMI only if it is written by a highly rated company. ACB believes that pool insurance and other types of guaranty programs do help reduce risk and should be considered in risk weighting mortgage loans. We suggest that the agencies recognize these risk mitigation methods consistent with the recourse provisions in the agencies' capital guidelines on asset securitization. Also, mortgage insurance protection provided under special policies for loans sold to a Federal Home Loan Bank under its mortgage purchase program should be fully recognized when determining capital requirements for recourse obligations associated with those sold loans.

For the reasons discussed above, we believe that PMI should be recognized for all types of mortgage products, without regard to the characteristics and terms of the mortgage. We see no reason to treat certain mortgage loans differently if they are covered by PMI.

Nor do we see a need for risk-weight floors if PMI will be recognized only if written by highly rated companies.

Second Liens. The proposal discusses the treatment of second liens, which would differ depending on whether the institution also holds the first lien on a property. If an institution holds a first and second lien, including a home equity line of credit ("HELOC"), the loans can be combined to determine the LTV ratio and the lender can apply the appropriate risk weight as if it were one first lien mortgage. We believe that institutions should have the choice to treat first and second liens as separate risks. The first lien carries less risk and is more likely to be repaid in full, so it should carry a lower risk weighting than the second lien. For example, a first mortgage with an 80 percent LTV should not have its risk-weight adjusted from 35 percent to 100 percent if the borrower also carries a second bringing the LTV to 95 percent. Such an effect will likely cause the lender to be less willing to extend the second lien, forcing the borrower to utilize alternative lending sources and incurring much higher borrowing costs/fees in obtaining the second mortgage.

For stand-alone seconds or HELOCs, if the LTV at origination for the combined loans does not exceed 90 percent, the agencies propose a 100 percent risk weighting. If the LTV is over 90 percent, the agencies believe a risk weight higher than 100 percent would be appropriate. We do not support this approach. Again, the weighting should be more closely aligned with the actual risk. It should not be set in a way that forces lenders to forego second liens because the capital requirements are not proportional to the risk. The result of the proposal is that if the lender holds a first mortgage with an 85 percent LTV, that loan would have a risk weight of 50 percent. If the lender holds only a second mortgage where the combined LTV is 85 percent, the risk weight for the second mortgage is doubled to 100 percent even though the risk is the same based on an LTV ratio. We do not believe this is the proper result.

Capital treatment of first and second liens, regardless of whether the same institution holds both, should be consistent to avoid gaming of the system or unnecessary burdens on borrowers who might have to spend more time and money securing second mortgages. We also believe that PMI should be factored in when determining the risk weight of a second lien just as it would be for a first lien.

Multifamily Residential Mortgages

Multifamily residential mortgages currently receive a risk weighting of 100 percent, except for certain seasoned loans that may qualify for a 50 percent risk weighting. The agencies are seeking comments and supporting data as to whether there are ways to differentiate among these loans with regard to risk.

We believe that a stratification of these loans into three or four risk buckets, similar to single-family residential loans, would be appropriate. We recognize that the risk weighting for these loans would have to take into account the higher risk of this type of lending. Since LTV ratios are the most accurate predictor of a mortgage loan's risk, we

believe that the buckets should primarily be based on these ratios. However, we also believe that the number of units financed also should be considered. For example, loans could be classified as fewer than 20 units, 20 to 36 units, and more than 36 units. The number of units is correlated with the size of the loan and the size of the loan is associated with risk. Appropriate risk weight buckets could be determined by consulting with banks and savings associations experienced with multifamily residential mortgage lending through periods of economic stress.

Other Retail Loans

The agencies have requested information on alternatives for structuring a risk-sensitive approach for consumer loans, credit cards and automobile loans.

We believe that LTV ratios for automobile lending and other secured consumer lending should be used to differentiate risk at the option of the institution. There are objective, standard resources for determining the value of an automobile. Other types of collateral that have objective means for determining value also should be considered. Those institutions that are willing to collect, update, and report this information should have the option of using LTV ratios to better align capital requirements with credit risk.

For automobile loans, credit card lending, and certain types of unsecured consumer loans, loan term can be used to differentiate risk, with less risk assigned to shorter terms. Credit scores or debt-to-income ratios also could be used to differentiate risk at the discretion of the institution. As with mortgage loans, there is no evidence indicating which measure is more accurate as a barometer of risk. Those institutions that are willing to collect, update, and report this information should have that option. Other institutions that would prefer less burden should be able to comply with simpler, more straightforward requirements such as risk weights based only on LTV ratios and loan term.

Commercial Real Estate Exposures

The agencies have long had supervisory concerns with loans made for the acquisition, development and construction ("ADC") of commercial property. Currently, these loans are subject to 100 percent risk weighting. The agencies are considering increasing the risk weight above 100 percent unless the loan meets certain conditions, including complying with interagency real estate lending standards and having long-term borrower equity of at least 15 percent. The agencies request comment on this approach and also on whether there are other types of risk drivers, such as LTV ratios or credit assessments that could be used to differentiate the risk of these loans.

We understand the concerns that the agencies have had with commercial real estate loans. However, capital requirements should be proportionate to the risk to ensure that prudent ADC lending is not discouraged. Our main objective in this area would be that Basel I banks be treated as similarly as possible to Basel II banks. This is a primary area of lending where our member community banks compete with the larger banks and they should not be left at a competitive disadvantage.

We support the approach in the proposal that would provide lower risk weights for loans that meet certain conditions, such as compliance with appropriate underwriting standards and the presence of an appropriate amount of long-term borrower equity. LTV ratios and other drivers of credit risk, such as loan term and borrower equity, should be considered, at the discretion of the institution. This could be done by slotting these loans into two or three buckets with different risk weights based on the characteristics of the loan and the additional risk drivers.

There have been concerns among our members that the general reference to ADC loans in the ANPR could be interpreted to include loans to residential real estate developers. ACB would strongly oppose the application to residential ADC loans, as these types of loans do not involve the same type of risk as more speculative loans to commercial builders. We would appreciate having clarification that these ADC provisions would not apply to single-family homebuilders and developers.

Small Business Loans

Small business loans currently are assigned to a 100 percent risk-weight category unless covered by acceptable guarantees or collateral. The agencies are considering reducing the risk weight for small business loans to 75 percent if certain conditions are met, such as full amortization of the loan within seven years, no default in contract provisions, full collateral coverage, and application of appropriate underwriting guidelines. Small business loans would be those loans under $1 million on a consolidated basis to a single borrower.

An alternative approach would be to use a risk weight based on the credit assessment of the principal shareholders and their ability to service the debt when the shareholders provide a personal guarantee.

We support the proposed approach that would provide lower risk weights for small business loans that meet certain conditions, such as compliance with appropriate underwriting guidelines, no defaults, and full amortization over a seven-year period. We question, however, whether full collateral coverage should be required. We would prefer an approach that provides two or three different buckets based on LTV ratios, with lower ratios receiving lower risk weights. To provide even more alignment with risk, loans could be slotted into buckets based on the loan term, with shorter terms receiving a lower risk weight.

An alternative option could be offered that would allow an institution to base the risk weight on the credit score or debt-to-income ratio of a principal shareholder that guarantees the loan. Again, multiple buckets should be offered based on the results of the credit assessment.

We believe that the definition of small business loan should be changed to include those loans under $2 million on a consolidated basis to a single borrower. This would be

consistent with the clear definition of "small business loan" provided in the OTS lending and investment regulations.

Any approach that would revise the risk weights for small business loans should be optional to the institution. Only those institutions wishing to incur the burden of collecting, updating and reporting relevant information in exchange for more risk-sensitive capital requirements should have to incur any increase in burden. Some institutions may find that maintaining and reporting data on loan terms for small business loans may not warrant the requirement to maintain, update and report on collateral value and LTV ratios. Other institutions may find it less burdensome to rely on a guaranteeing shareholder's credit assessment. It is better to provide as much flexibility as possible without over-taxing the resources of the institutions or the agencies.

Use of External Credit Ratings

The agencies propose allowing institutions to assign risk weights for certain assets by relying on external credit ratings publicly issued by a recognized rating agency. For example, a commercial loan to a company with the highest investment grade rating would have a 20 percent risk weight, while the lowest investment grade rating would receive a risk weight of 75 percent. Exposures with ratings below investment grade could receive a capital charge up to 350 percent. The agencies would retain the ability to override the use of certain ratings, either on a case-by-case basis or through broader supervisory policy.

We do not support the use of external credit ratings in determining the risk of commercial loans without some comparable method for determining the risk of unrated companies. Ratings are designed to measure the likelihood of default, but not the likelihood of a loss. The rating also does not reflect the fact that an institution may have purchased the loan at a discount. Many community bank commercial loans are made to businesses that are not assigned credit ratings, but are good credit risks with low probability of default. It would be unfortunate if capital requirements discouraged lending to very strong companies who help create jobs in the community simply because the company is not rated by a recognized rating agency. We support capital requirements for commercial loans that are simple, encourage approval of loans to creditworthy, unrated businesses, and avoid any competitive disadvantage to the community banks that make most of their commercial loans to unrated companies.

We would support recognizing additional types of collateral and slotting these loans into risk buckets based on LTV ratios to differentiate the risk of commercial loans. There are objective sources available to calculate value for collateral such as real estate and equipment. Financial collateral, such as certificates of deposit held at other institutions, also could be considered.

Short Term Commitments

There currently are no risk-based capital requirements for commitments lasting less than one year. For commitments greater than one year, the commitment is converted to an on-balance sheet credit equivalent using a 50 percent credit conversion factor ("CCF").

The agencies are considering applying a 10 percent CCF for short-term (less than one year) commitments, with the amount then risk-weighted according to the underlying asset. This would not apply to commitments that are unconditionally cancelable at any time or that effectively provide for automatic cancellation based on credit deterioration. An alternative suggestion is to apply a CCF of 20 percent to all commitments, whether short or long term.

We believe the substantial cliff effect that occurs with short-term commitments should be removed by applying a CCF of 20 percent to all commitments regardless of term. Commitments that are unconditionally cancelable at any time or that effectively provide for automatic cancellation should have a CCF of zero.

Past-Due Loans

The agencies are considering assigning higher risk weights to exposures that are 90 days or more past due and those on nonaccrual. The amount at risk, however, would be reduced by any reserves directly allocated to cover potential losses on the past-due exposure.

We do not support this approach. Current regulatory requirements provide that depository institutions set aside reserves and take other steps to mitigate the risk of these loans and their impact on the institution. The proposal does not take into account the improvements to risk management systems developed by lenders that call for quick intervention to resolve payment issues. Finally, automatic upward adjustments for past due loans do not take into account LTV ratios or other relevant risk drivers that could reduce the amount of loss upon default.

Use of Collateral and Guarantees to Mitigate Risk

The agencies propose to allow greater use of collateral and guarantees to reduce the capital requirements for exposures. Currently, the only collateral recognized in the capital rules is cash and certain government, government agency and government-sponsored enterprise securities. The list of recognized collateral would be expanded to include short- or long-term debt securities that are externally rated by a recognized rating agency. Portions of exposures collateralized by these instruments would be assigned to risk-weight categories according to the risk weight of the instrument. To recognize more types of collateral, an institution would need a collateral management system in place that tracks collateral and can readily determine its value.

The agencies also are considering increasing the types of recognized guarantors. The list would be expanded to include entities whose long-term senior debt has been assigned an external credit rating of at least investment grade. We believe that any expansion of the types of eligible collateral and the use of guarantees could be useful, but this should be optional, as some institutions may find tracking of collateral and the management of guarantees to be overly burdensome and unjustifiable. Also, the institutions that would benefit from such a change are those that take externally rated collateral or get guarantees from rated organizations. Many community banks do not take collateral in the form of rated securities. Also, although many of our members get personal guarantees for small business loans and commercial loans, these guarantees are from individual shareholders and not guarantors with externally rated long-term senior debt. We do not believe that allowing the use of externally rated debt securities and guarantors in order to get more risk-sensitive capital requirements will change the behavior of community banks with regard to how they underwrite and collateralize small business and commercial loans.

As discussed above, we think the types of recognized collateral should be expanded to include other items types of collateral that are used to secure commercial loans and that have objective sources of valuation. This would include real estate and industrial equipment as well as financial collateral such as certificates of deposit held at other institutions.

Leverage Ratio

The regulators propose to keep the leverage ratio requirement in place for both Basel I and Basel II institutions. We believe that a regulatory capital floor must remain in place to mitigate the imprecision inherent in the internal ratings-based system to be used by Basel II banks and to provide a safeguard for Basel I banks. However, the precise level of the leverage requirement should be open for discussion, so that consideration might be given to allow institutions that comply with Basel II and Basel I-A to more fully achieve the benefits of more risk-sensitive capital requirements.

Risk Modeling Approach

We would like the agencies to consider establishing a simple risk modeling system for use by community banks, much like the OTS developed for interest rate risk modeling used by savings associations. The modeling approach could establish capital levels that more clearly reflect each institution's actual risk levels without adding the significant costs of implementing the more sophisticated approaches in Basel II. An alternative might be a private industry approach whereby third party vendors could develop simplified internal ratings-based systems subject to regulatory review. This would give smaller institutions the proper incentive to improve their risk management and measurement systems, notwithstanding the fact that they do not possess the expertise to develop such systems internally. If such an approach is not deemed to be practical for all asset categories, it could at least be considered for commercial loans. Such a modeling

approach could be based on similar ratings systems established by private, third-party firms that are readily available for business loans.

Other Issues

We support the use of more risk weight categories and the ability to more accurately differentiate among all balance sheet assets, not just those mentioned in the ANPR. For example, certificates of deposit of less than $100,000 held in insured depository institutions and similar correspondent bank deposits should receive a zero risk weighting, rather than the current 20 percent. Land and buildings could get lower risk weights based on appraised and net book value. Accrued interest on loans could be slotted in the same bucket as the loan itself.

We believe that institutions that prefer to remain on Basel I, without additional changes, should be permitted to do so regardless of size. There are some institutions that do not see the need, either from a management and operational perspective or a competitive perspective, to have more risk-sensitive capital requirements. For these institutions, the choice to avoid any regulatory burden associated with changes to the capital requirements should be respected. We see no reason why this choice should be limited to institutions of a particular size. Regulators are accustomed to supervising compliance with current Basel I. To the extent a significant number of institutions choose to remain subject to Basel I without change, this could also reduce the burden on the regulatory agencies.

We also believe that institutions should be afforded some flexibility in the approach used to obtain more risk-sensitive capital requirements. For many of our members, the ability to have more risk-sensitive capital requirements only for residential loans would be sufficient to mitigate any competitive disadvantage they would face with regard to Basel II banks. Some institutions may be interested in more risk-sensitive capital requirements only if is comes without significant burdens to compliance. Other institutions are willing to spend significantly more initial resources in order to attain capital requirements that can be even more closely associated with risk. For instance, some of our members may be satisfied with weighting the risk of their mortgages solely by LTV ratios, while others may be willing to incur greater burden by also taking into account credit scores or debt-to-income ratios. We believe that the more flexibility that can be provided, without unduly burdening the regulatory agencies, the better it is for the industry.

The agencies also should consider whether the creation of a risk sensitive Basel 1-A could be applied to the entire industry, rather than single out some of the largest banks for compliance with Basel II. In light of the implementation issues that have arisen with Basel II, and ongoing concern about the use of sophisticated internal ratings-based models in the advanced approach to determine capital requirements, one overall framework may be a more useful and appropriate approach. At a minimum, we believe that Basel II banks should be allowed to utilize the Basel I-A model as a floor during the three-year implementation phase of Basel II.

Our members understand that in order to get the benefit of more risk-sensitive capital requirements, they will have to provide more information to the agencies on Call and Thrift Financial Reports. However, we believe that the changes made to the reports should be limited to those necessary for the agencies to adequately supervise compliance with the capital requirements. We also believe that it is important to give institutions choices, so that they can decide to adopt only certain changes to capital requirements in order to keep their reporting burden in check.

ACB appreciates the opportunity to provide this comment letter and intends to remain engaged on this important matter. If you have any questions, please contact the undersigned at (202) 857-5088 or via e-mail at rdavis@acbankers.org, or Sharon Lachman at (202) 857-3186 or via e-mail at slachman@acbankers.org.

Sincerely,

Robert R. Davis
Executive Vice President and
Managing Director, Government Relations

APPENDIX B

April 7, 2006

Office of the Comptroller of the Currency
250 E Street, SW
Public Information Room
Mail Stop 1-5
Washington, DC 20219
Attn.: Docket No. 05-21

Regulation Comments
Chief Counsel's Office
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Jennifer Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th St. and Constitution Ave, NW
Washington, DC 20551
Attn.: Docket No. OP-1246

Re: Proposed Guidance- Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices
71 FR 2302 (January 13, 2006)

Dear Sir or Madam:

America's Community Bankers (ACB)[3] appreciates the opportunity to comment on the Proposed Guidance – Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices[4] ("Proposed Guidance") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the "Agencies").

ACB Position

Commercial real estate lending is an extremely important part of lending for community bankers. We understand the Agencies are concerned that "some institutions may have high and increasing concentrations of commercial real estate loans on their balance sheets

[3] America's Community Bankers is the member driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit www.AmericasCommunityBankers.com.
[4] 71 FR 2302 (January 13, 2006).

and are concerned that these concentrations may make the institutions more vulnerable to cyclical commercial real estate markets."

ACB supports the Agencies' position that "...institutions should have in place risk management practices and capital levels appropriate to the risk associated with these concentrations." We understand that the Proposed Guidance reiterates previously issued guidelines and regulations for safe and sound commercial real estate ("CRE") lending programs. We believe it is always prudent for the Agencies to remind lenders periodically of these elements of responsible lending practices. Generally, our members follow these principles in their commercial lending programs.

However, ACB believes it is extremely important for the Agencies to recognize the extensive burden that would be imposed on community banks by certain provisions in the proposal regarding risk management requirements for institutions engaged in CRE lending. To alleviate some of the burden, we recommend that, at a minimum, the Agencies' risk management examinations take into account the size and complexity of the institution and its CRE loan portfolio.

The Proposed Guidance contains an expansive definition of what constitutes CRE loans. CRE loans are defined to include exposures secured by raw land, land development and construction (including 1-4 family residential construction), multi-family property and non-farm nonresidential where the primary or a significant source of repayment is derived from rental income associated with the property or the proceeds of the sale refinancing or permanent financing of the property.

Following the expansive definition of CRE, the Proposed Guidance introduces rigid threshold tests by disparate types of loans for assessing whether an institution has a commercial real estate concentration that triggers heightened risk management practices and heightened regulatory scrutiny. We believe that the thresholds proposed by the Agencies are arbitrary and do not reflect the different types of lending. Further, we believe the thresholds will not accurately identify institutions that might be adversely affected by their commercial real estate portfolio in an economic downturn.

The proposal also calls for lenders with concentrations of CRE loans to increase their capital levels above regulatory minimums. ACB questions the inclusion of capital guidance in the Proposed Guidance. We recognize that discretion and judgment are part of how the Agencies' assess an institution, but we strongly believe that the application of discretion in this instance based on a faulty threshold test is inappropriate. Any requirement that an institution must raise extra capital should be imposed by regulation through the "risk based capital" rules currently being considered by the Agencies.[5]

Our explanation for these positions follows. In addressing the Proposed Guidance, we have segmented our comments into three areas: Concentration Tests, Risk Management Principles and Capital Adequacy.

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[5] 70 FR 61068 (October 20, 2005)

CRE Concentration Tests

ACB believes that the CRE concentration thresholds are inappropriate and that the proposed test formulas are severely flawed. The tests, as proposed, seem to be arbitrary and they ignore important differences in the compositions and characteristics of individual lenders' CRE portfolios.

The Agencies already have complete authority to implement additional oversight of any individual institution. Arbitrary thresholds that do not consider the specific circumstances of individual lending institutions may force some lenders out of the CRE market, creating an unnecessary and unintended shortage of credit. This could make it difficult for developers to fund their projects or force them to seek credit from non-federally regulated financial institutions.

We believe the soundness of an institution's CRE portfolio depends on individual characteristics of the portfolio and the institution's CRE underwriting capabilities and experience. Accordingly, each institution should continue to be evaluated on a case-by-case basis as part of the ongoing safety and soundness examination. This evaluation should be based on the overall capital structure of the institution, delinquency trends and historical losses, composition of the CRE portfolio, performance of that portfolio and the quality of underwriting including classified loans, delinquency trends and losses, demographics of the market served and the level of management controls in place at each institution.

Further, it is a mistake to combine all types of CRE loans into a single risk classification for purposes of setting thresholds. Different types of commercial real estate have very different risk profiles. For example, it is important to differentiate speculative CRE loans for raw land, land development, contractor spec home construction, and commercial construction and development from non-speculative CRE loans that either have firm takeouts or established cash flow patterns.

Home construction and multifamily mortgages with firm takeouts or established rent rolls, for example, have much less risk than CRE loans that have no firm takeout or established cash flow history. The Agencies' have the ability to look at loss histories, which would confirm this assessment. Home construction loans that are matched to pre-qualified takeout buyers who are contractually bound to close the loans upon completion also have low risk.

Completed multifamily properties, including apartments, rental complexes, assisted living complexes, etc., with established performance for occupancy, rent rolls and operating expenses have significantly less risk than non-multifamily CRE loans that have no such history. Multifamily mortgages historically have had much lower loss ratios than certain other loan classifications included in the tests. In an economic downturn, multifamily loan performance tends to run counter-cyclically to other types of real estate,

such as single-family mortgages, because potential homebuyers are more likely to rent than to purchase a home.
The proposed tests mix together real estate loans with vastly different potential for loss, and therefore fail to accomplish the Agencies' goal of identifying institutions that might be adversely affected by their commercial real estate portfolio in an economic downturn. Therefore, we do not believe that either of the threshold tests is appropriate or accurate.

However, if the Agencies deem it necessary to impose threshold tests, the tests should be modified to correspond to the actual risk inherent in the portfolio. ACB believes that multifamily loans, pre-sold residential construction and construction/permanent financing with either firm takeouts or established cash flows that provide sufficient debt service coverage should be excluded from the definition of CRE loans. This change will allow the Proposed Guidance to focus on those types of speculative loans that are most susceptible to economic downturns.

In order for the final guidance to exclude the aforementioned types of CRE loans or to make the tests correspond to distinct loan risk profiles, we understand that certain refinements would be required in the Call Reports and Thrift Financial Reports to enable an accurate breakout of different loan classifications, and we support such changes. Also the Call Reports and Thrift Financial Reports currently do not break out CRE for owner-occupied properties, which are excluded from the CRE definition in the Proposed Guidance. However, we understand that the Agencies will modify the reports in 2007 to address this problem.

CRE Risk Management Principles

The Proposed Guidance outlines the Agencies' view of what constitutes a "sound commercial real estate lending program." These regulatory guidelines cover the following areas: board and management oversight of CRE lending; the incorporation of a section on CRE lending in each institution's strategic plan; underwriting guidelines for CRE loans; risk assessment and monitoring of CRE loans; CRE portfolio risk management practices; the need for management information systems that can produce "meaningful information on CRE loan portfolio characteristics," policies for identifying and classifying CRE loan concentrations; the need for market analysis; portfolio stress testing; and developing an adequate allowance for CRE loan losses.

ACB recognizes that most of these "risk management principles" have been in effect for some time and are generally acknowledged by the industry as prudent standards that should be used by any institution engaged in CRE lending. However, ACB strongly believes that an institution's risk management practices should be appropriate for the size and complexity of the individual institution. The risk management examination for a small institution should not be the same as for a large, complex institution.

It would be extremely difficult for many community institutions to routinely "stress test" their entire CRE portfolios. Community banks engaged in CRE lending routinely "stress test" each CRE loan at the time of origination as a part of their normal credit

underwriting loan approval process and, also, on a periodic basis as part of an ongoing portfolio concentration review process. Few community banks today, however, have the financial software and sophisticated data bases to periodically stress test their entire CRE loan portfolios. Thus, adoption of the Agencies' proposal would impose a significant new regulatory burden and cost on these institutions.

Financial Institution Capital Adequacy

ACB also acknowledges that financial institutions engaged in CRE lending should be capitalized adequately and that the capital levels should be based on the inherent levels of risk being taken by the financial institution in their various loan portfolios. We also firmly believe that the appropriate place for the capital guidance in the risk based capital rules—not in this guidance.

To determine the appropriate capital level for an institution engaged in making CRE loans, ACB believes that the regulators should take into consideration the following factors:

- The experience and past performance of the institution in making specific types of CRE loans;
- The inherent risk of each product type of CRE loan (e.g., multifamily, office, retail, warehouse, hotel, acquisition and development, new construction, special purpose, etc.);
- The dynamics of the geographic markets being served by the financial institution and
- The quality of the institution's risk management practices.

We believe that the appropriate mechanism by which the Agencies should impose such a mandate for extra capital, based on the factors listed above, is by regulation in the "risk based capital" rules currently being considered by the Agencies.[6] In fact, in our comment letter to the Agencies' on the Basel 1a proposal, we specifically suggested the following as it relates to CRE:

- The risk criteria that should be taken into account to differentiate multifamily residential mortgages should be LTV ratios and number of units. A similar approach to the buckets for single-family residential mortgage loans should be used to stratify these mortgages based on risk.

- We support the approach in the proposal that would provide lower risk weights for commercial real estate loans that meet certain conditions, such as compliance with appropriate underwriting standards and the presence of an appropriate amount of long-term borrower equity. In order to ensure that Basel I banks are not put at a competitive disadvantage with regard to Basel II banks for the

[6] 70 FR 61068 (October 20, 2005)

treatment of commercial real estate, we believe institutions should be provided an option to risk-weight these loans in additional buckets using LTV ratios and loan terms as risk drivers.

- While we support the use of credit ratings as a factor in determining the risk of commercial loans, we also urge the Agencies to allow banks to use additional types of collateral and LTV ratios when no credit rating exists. Many community banks make both large and small commercial loans to borrowers that do not have a credit rating. We believe the permitted use of additional non-rated collateral LTVs will help keep capital requirements fairly simple, encourage lending to creditworthy and unrated businesses, and avoid any potential competitive disadvantages.

- We believe that any expansion of the types of eligible collateral or guarantees that can be used to mitigate risk should be optional for the institution. Institutions that want to keep capital requirements simple and do not want the added burden of continually tracking collateral should have that option.

We strongly oppose any requirement that an institution increase its capital levels based only on the fact that the institution may have a concentration of CRE loans.

Conclusion

Not only is commercial real estate critical to the lending programs of many community bankers, it is essential to the health of the American economy. Any guidance that imposes additional requirements in a mechanical or arbitrary manner could lead to policy shifts in the lending practices of community banks that could discourage CRE lending. Diminished CRE lending could also have a negative impact on our economy in general and contribute to an economic downturn. It is important to note that one of the only remaining lending categories with which community banks can compete and serve their communities effectively is CRE lending.

For the reasons described above, we strongly recommend that this guidance be redrafted and made workable. ACB urges the Agencies to avoid imposing regulatory burdens in the risk management area that are disproportionate to the size and complexity of an individual institution.

ACB also recommends that the Agencies eliminate rigid, arbitrary threshold tests that ignore the actual risk factors associated with a particular loan or portfolio. If the threshold tests must be used and are to be useful tools at all, they should be flexible and much more refined, and should not to combine together CRE loans with vastly different potential for losses.

The Agencies also should not require an institution to increase its capital levels simply because the institution has a concentration of CRE loans. Appropriate capital levels

should be determined based on a thorough analysis of the individual institution and any requirement for an institution to hold extra capital should be imposed by regulation in the "risk based capital" rules and not by this proposed Agency guidance.

ACB appreciates the opportunity to comment on this important matter. If you have any questions, please contact the undersigned at 202-857-3129 or jfrank@acbankers.org.

Sincerely,

Janet Frank
Director, Mortgage Finance

Testimony of

Glenn R. Mueller, Ph.D.

Before the

Subcommittee on Financial Institutions and Consumer Credit

Of the

Committee on Financial Services

United States House of Representatives

September 14, 2006

Real Estate Space Market Cycles

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Key Points

- The proposed banking agency guidance on commercial real estate lending concentrations appears to be predicated on fundamental misconceptions of how the commercial real estate market functions today.
- Today's commercial real estate market is very different from the one that existed in the late 1980s and early 1990s. For example, the commercial real estate markets and their cycles are much more transparent today than they were a decade ago. This increased market transparency should make future real estate cycles longer and less volatile.
- The proposed guidance also appears to be based on the faulty premise that all types of commercial real estate move in the same cycle and that the residential real estate market and commercial real estate market are closely correlated.
- Real estate space market cycles are different for each metropolitan area and for each major property type (Office, Warehouse, Retail, Apartment and Hotel). Thus, the Chicago office market and the Chicago retail market can be in very different places; and the Chicago retail market can be at a different point in its cycle than the Miami or New York retail market. Space market cycles depend upon local economics of supply and demand.
- The real estate asset class has two major groups – Residential (home ownership) real estate and commercial (income producing) real estate such as Office, Warehouse (industrial), Retail, Apartment and Hotel.
- Residential Ownership (housing) is not connected or correlated with commercial income producing real estate.
- Residential real estate markets and commercial real estate markets are fundamentally different. Residential real estate is a production process that counts on consumers to purchase newly built and existing inventory. Commercial real estate is an investment process that rents properties to businesses and consumers. New commercial properties are owned by investors and only built when there is sufficient new demand.
- Banks that lend for new residential construction take a risk of unsold inventory. Banks that lend for new construction of commercial real estate require that a take-out permanent mortgage be in place (reducing the pay-off risk) and banks that lend on permanent commercial mortgages require the property be pre-leased to provide cash flow to pay mortgage payments (reducing default risk).
- The space market cycle of the 1970s was 10 years long, the next cycle was 21 years long (1979 to 2000) and the future space cycle is expected to be longer and less volatile due to fundamental changes that have taken place in the commercial real estate market place.
- The current commercial space market cycle declined from 2000 to 2003 and hit an occupancy bottom in 2003. Price declines and loan defaults did not happen in this down cycle like they did in 1990. The space market cycle is still in the recovery phase for most property sectors today with a peak expected after 2010.
- The growth phase of this cycle should start in 2008 for most property types although retail is already in a growth phase.
- The space market cycle is local in nature, driven by local employers (demand) and builders (supply).
- Demand and Supply drive occupancy rates which drive rental growth.
- Occupancies and Rents drive earnings which pay mortgage payments.

- The severe downturn that occurred in the commercial real estate market during the late 1980s and early 1990s was triggered by factors that are not present in today's environment, such as (i) changes to the Internal Revenue Code in the 1980s that encouraged people to make investments in tax shelter commercial real estate that were not based on the underlying profitability of the project, and (ii) the expansion of lending powers of thrifts that allowed them to make commercial real estate loans for the first time, and thus introduced numerous inexperienced lenders into the market. These factors led to overbuilding.

- The potentiality for a commercial real estate bubble has significantly decreased because of the introduction of Public Market Capital from Real Estate Investment Trusts (REITs) and Commercial Mortgage Backed Securities (CMBS). This introduction of public capital has changed the dynamics of the space market cycle.

- *Real Estate Space Markets* can move differently from *Real Estate Capital Markets.*

Purpose of This Written Testimony

Earlier this year, the federal banking agencies issued proposed guidance entitled "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" (the "Guidance"). The proposed Guidance sets forth certain thresholds for assessing whether an institution has commercial real estate loan concentrations that would trigger heightened risk management practices and potentially higher capital requirements. After analyzing the proposed Guidance, it appears that it is predicated on fundamental misconceptions of how the commercial real estate market functions today. These misconceptions seem to be based on the assumption that this market has not witnessed fundamental changes over the last two decades. Simply stated, today's commercial real estate market is very different from the one that existed in the late 1980's and early 1990's. For example, the commercial real estate markets and their cycles are much more transparent today than they were a decade ago. This increased transparency allows investors, developers and lenders to react much more quickly to market risks and substantially reduces the potential for overbuilding. This increased market transparency should make future real estate cycles longer and less volatile.

Another misconception underlying the proposed Guidance is the apparent belief by the banking agencies that all types of commercial real estate (Office, Warehouse, Retail, Apartment and Hotel) move in the same cycle and, thus, bear the same risk. This is simply not true. Commercial real estate cycles are different for each metropolitan area and for each major property type. This is shown in the attached Market Cycle report (Appendix A). The Guidance's one-size-fits-all approach does not take into account diversification by geography and product type.

The definition of commercial real estate in the proposed Guidance also appears to be based on the misconception that the residential real estate market and commercial real estate market are correlated to such an extent that certain types of residential loans should be included within the definition of commercial real estate for purposes of the proposed Guidance. This is a faulty premise because the commercial real estate market and the residential real estate market are fundamentally different.

Commercial real estate is a necessary and important part of economic growth. In order to avoid any potential unintended consequences, the bank regulatory approach to commercial real estate lending must be predicated on an accurate understanding of today's commercial real estate market environment. The purpose of this written testimony is to set forth the changes that have occurred in the commercial real estate market over the last two decades in order to address the misconceptions upon which the proposed Guidance appears to be based.

Real Estate Space Market Cycles

Introduction
Many economists consider commercial real estate cycles to be a mirror reflection of the economy. As one of the three major factors of production (land, labor and capital) demand for commercial real estate is a necessary and important part of economic growth. As the population of the world grows, these additional people need a place to work, sleep, eat, shop and be entertained which constantly increases the amount of space needed. Many consider commercial real estate a cyclical industry because its demand side is affected by economic cycles and supply historically lags demand.

Historically, the delivery of real estate **space** to meet the world's needs has been "lumpy". Too little space is available during times of rapid growth and once development production has geared up too much supply continues to be produced even after demand has slowed. This lag between demand growth and supply response has been a major cause of volatility in real estate cycles, after the effect of economic cycles. The ability to control space production is one key to less volatile real estate cycles in the future. This testimony explains the fundamental reasons for historic movements in the office **space market** demand and supply, and then attempts to project the demand and supply variables for the next cycle. While estimating the space market building cycle is relatively straightforward with much data available for both the demand and supply variables, projecting the **capital cycle** is much more difficult, as other investment markets (stocks, bonds and international investments) must be considered because they compete for investor's dollars.

Commercial vs. Residential
Please note that this testimony is focused on commercial (for rent) real estate markets and NOT residential (for sale) home ownership markets. Residential (for sale) home ownership markets are a production process, where new inventory is produced for consumers with the assumption that they can afford to purchase and will purchase homes. Residential construction lending has higher risks as unsold homes do not produce cash flow to make mortgage payments. (This does NOT include apartments.) Commercial (for rent) real estate monitors the occupancy levels and rents of existing properties as well as new construction added to the existing supply and examines it against the existing business tenants who rent properties and new tenants who may come into the market. Historically the residential and commercial markets have had very different cycles and thus very different value changes and/or problems.

Space Market Cycle Fundamentals
The **"space market" cycle** is the demand and supply for space, which is **very local in nature**. Demand for space is a function of the number of people who need space to live and businesses that need space to conduct their business. The amount of space used is a function of both the need for space and the price of that space. The supply of space is a function of existing space, space under construction, and future demand for space. Rent is a function of the current space available (occupancy level) and the future expected space available.

The cost to purchase or construct space must provide an economic return for the investor. Most researchers have found that rents are a function of the amount of demand and supply at any given point in time. The interplay between demand and supply is easily described in terms of occupancy (or vacancy), which has a high correlation with rent levels. The supply and demand for space is also property specific. Demand and supply for office space does not affect the demand or supply for retail, warehouse, hotel or apartment space. Thus an investor or lender who diversifies their portfolio by both property type and market can lower their risks substantially. *This analysis uses the historic office markets as an illustration, but similar cycles appear in the other four major property types including warehouse, retail, apartment and hotel.* The current positions of the 5 major property types and the 50+ major metropolitan areas can be seen in the Market Cycle Report attached as Appendix A.

The 1970s Cycle
Demand: The 1960s had average annual overall office employment growth of 3.2% for the decade which produced strong demand for office real estate into the late 1960s. The first half of the 1970s produced only 1.8% average annual office employment growth, partially due to a recession in 1974 and office demand increased by only 1.7% in the early 1970s. The second half of the 1970s produced strong economic growth (GDP) from the baby boom generation coming of age and entering the work force with overall employment growth averaging 3.2% per year again. Office demand growth averaged 3.8% per year (faster than overall employment) during the second half of the 1970s as the information age began and the middle management ranks, who analyzed more data for companies, expanded. (Exhibit 1) Several office markets had sharp office demand growth from industry specific employment factors such as the oil boom in Denver, Dallas and Houston.

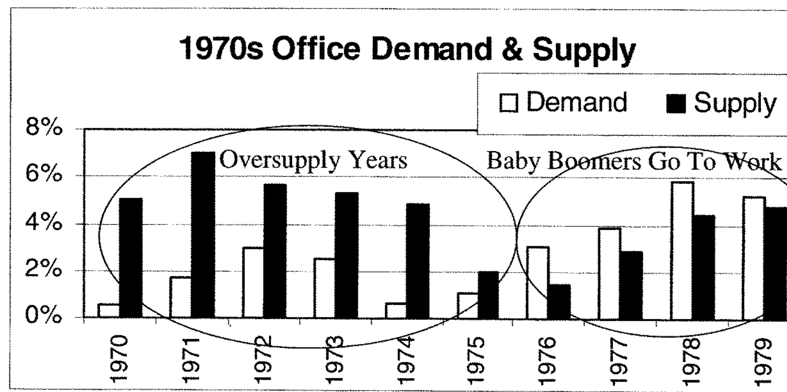
Supply: The early 1970s were characterized by a construction boom that was fueled by increased capital flows to real estate. Major new capital sources were available as mortgage REITs were created by commercial banks that allowed them to bypass their regulatory restrictions on how much and how many real estate projects they could lend to. The first half of the

1970s saw total office space construction increase by an average 5.6% per year. The recession of 1974 slowed GDP and employment growth, and the office markets down-cycled and crashed in 1974 and 1975. Many construction loans defaulted and never converted to permanent loan status. New "empty buildings" were foreclosed upon and held by mortgage REITs whose stock values plummeted from a peak NAREIT Index of 112.39 in January 1973 to a low 39.09 in December 1974, when the mortgage REITs could not make their dividend payments. The REIT industry, which had begun in 1960, grew to around $10 billion in market capitalization and subsequently shrunk to $2 billion in 1975. The flow of capital to real estate construction shut down and new space growth slowed to 1.5% in 1976 then recovered to a more moderate 3.2% average in the second half of the 1970s.

The early 1970s period of overbuilding was initiated due to surprisingly strong demand growth in the late 1960s that allowed the capital markets to "sell a story" about mortgage REITs to public investors. Oversupply pushed office occupancies to a bottom in 1975 (Exhibit 5). After the crash, the public market branded mortgage REITs as "bad and high risk" and this mortgage REIT branding still exists today in the minds of many investors.

Exhibit 1 shows the high rate of growth in supply and relatively low rate of growth in demand in the first half of the 1970s causing a down cycle, while the second half was characterized by stronger demand growth than supply growth allowing recovery and then expansion to take place.

Exhibit 1



Source: FW Dodge, CB Commercial, BLS, Mueller

The 1980s Cycle

Demand: The U.S. began to move into the information age in the late 1970s and economic prosperity coupled with very strong white-collar employment growth from the baby boom generation helped create a 4.7% annual average GDP growth rate for the decade. A recession in 1981 was caused by high government debt pushing interest rates up to the high teens (10 year treasuries reached 15% in 1981) which caused construction spending and consumer spending to slow. After 1981 strong government spending, continued strong employment growth and the dawn of the personal computer age helped GDP to maintain strong growth rates throughout the rest of the 1980s. Employment growth averaged 2.8% per year for the decade while office demand grew an average yearly rate of 3.6% for the decade.

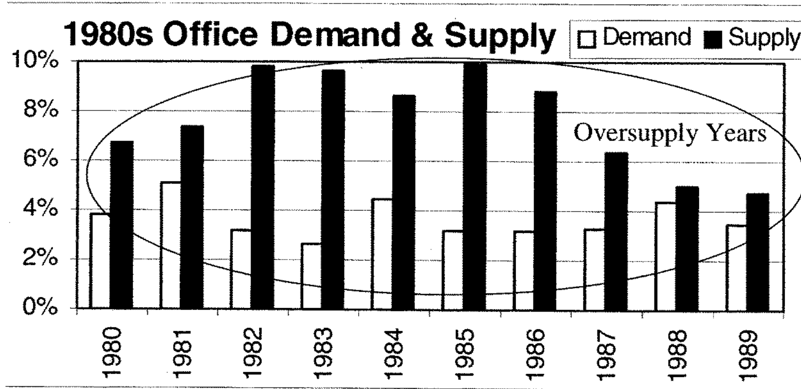
Supply: Real estate was a private marketplace in the 1980s, with little information available about construction starts versus future demand. In addition, thrifts were allowed to lend on commercial real estate where they had no previous experience. There were few researchers or national level data sources at the beginning of the decade and only a handful at the end of the decade. Data was provided by commercial brokers whose motivation was to close deals. Computers made 10 year investment projections a new way of life, but the standard occupancy assumption was 95% for each year going forward even when many market occupancy rates were declining. Supply was growing at an average 7.7% per year during the decade which was double demand growth, thus the occupancy rate was declining yearly. (Exhibit 5). The tax act of 1981 created more capital flow to real estate for tax shelters and thus more construction of tax driven (non-economic) real estate deals.

1982 was the peak construction year with an almost 10% growth in new supply. The few warnings by researchers about oversupply were not heeded. The tax act of 1986 did slow building, but not enough to bring supply growth back in line with demand growth (Exhibit 2).

This overbuilding was also driven by the search for higher returns by the capital markets. The first half of the 1980s produced a stock market return of almost zero and investors needed alternatives. Using their rear view mirrors, investors bought real estate as an inflation hedge and diversifier for their portfolios. With a track record that started in the early 1970s, pension fund investors saw historic real estate returns as a good alternative for diversifying their portfolios. The introduction of the NCREIF index in 1978 gave pension funds a benchmark to analyze real estate returns and more confidence to invest larger amounts. In addition, foreign investors saw U.S. real estate as a safe haven for their money and in the late 1980s the Japanese saw U.S. real estate as a much higher yield investment than their 3% real estate returns at home. This kept real estate prices rising and new construction coming, even though the occupancy rates continuously declined from 1979 through 1990. The construction boom did not stop until 1990 when the next buyer was not willing to pay a higher price for an empty office building and real estate prices finally crashed. Individuals, followed by pension funds, followed by foreign investors all had good "comparative" historic reasons to purchase real estate instead of stocks and bonds. Even the 1986 tax act (which took away the individual investor tax incentives) did not shut down commercial real estate investing and construction, as tax exempt pension funds and foreign investors kept on supplying capital to the office market. (Smith et al, 2000)

Shortages of office space in 1979 and 1980 and the ease of suburban office construction allowed for massive amounts of new speculative office construction in the 1980s. In addition, prosperous companies were building trophy downtown office buildings to show off their success and developers had no problem finding capital to put up speculative buildings to sell to investors. (Gilberto, 1992) Exhibit 2 shows the strong supply growth throughout the 1980s.

Exhibit 2



Source: FW Dodge, CB Commercial, BLS, Mueller

The 1990s cycle

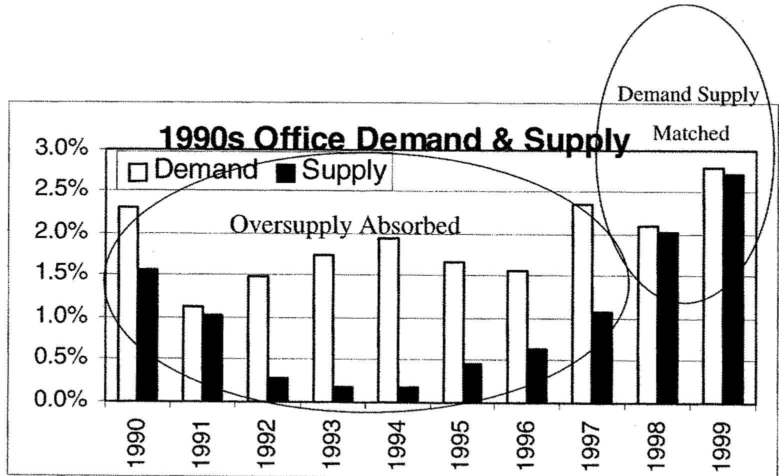
Demand: Office demand growth was relatively stable in the 1990s at an average growth of 1.9% per year with the only year below 1.5% being 1991, due to a mild recession. Office demand growth rose at over 2% from 1997 to 1999. The steady expansion of the economy with GDP growth averaging 3.1% per year in the 1990s is more moderate than previous decades, but much less volatile.

Supply: While both 1970 and 1980 saw real estate start the decade near a peak, 1990 saw the real estate cycle start at a bottom. Overbuilding in the late 1980s caused the worst vacancy in office space (over 20%) since the great depression and a mild recession in 1991 further reduced demand. It took until the mid-1990s for office markets to recover, on average, across the U.S. and the growth phase of the cycle did not begin until the second half of the 1990s. Little new construction

took place in the first half of the decade with supply growth averaging 0.6% per year, as the excess space built in the 1980s was being absorbed. Supply growth averaged only 1.3% for the second half of the 1990s, allowing occupancy to improve. Both 1998 and 1999 were years when demand and supply grew at similar rates, creating a balanced growth in the market. Rents improved throughout the second half of the 1990s as a result.

Bank and thrift failures in the late 1980s and early 1990s caused the government to create the Resolution Trust Corporation (RTC) to dispose of their bad loans and the commercial mortgage backed securities (CMBS) market was born. Developers who did have economic projects to build in other property types besides office could not find debt financing, so they turned to the public capital markets. The equity REIT market re-emerged in 1992 as a capital source for real estate. As the real estate markets improved, pension fund investors cautiously returned to the market and many tested the venture capital investment potential of real estate. With new technologies, public market investment and renewed but cautious interest from pension funds, data on real estate market activities became available during the 1990s and independent real estate research departments at investment firms became a standard for improved underwriting. Prudential Insurance, then Equitable Insurance, then most pension fund advisors established research departments by the mid-1990s with the head researcher having a PhD. Then the REIT boom of 1992 to 1997 caused every major investment bank on Wall Street to develop a REIT research team. The potential for overbuilding was reduced substantially as the research data from such companies as Torto Wheaton Research, FW Dodge, REIT Reports and Co-Star became available and real estate market watchdogs were ready to "blow the whistle" at the first sign of trouble. The higher information efficiency of the public markets and more freely available information has caused the ***feedback loop*** between supply and demand to become shorter. Real Estate capital providers now see problems within months instead of over a year and the public market capital is always trying to predict when to stop supplying funds to new and existing properties. 1998 and 1999 saw office demand and supply virtually match each other. (Exhibit 3) The Real Estate markets ended the 20th century in the healthiest cycle position since 1979.
Prior physical cycles indicate that when the U.S. economy grows rapidly, office development follows with a lag, and then supply tends to overshoot actual demand when completed buildings come on line. It was overly optimistic demand projections that created large amounts of oversupply in the last two historic cycles.

Exhibit 3



Source: FW Dodge, CB Commercial, BLS, Mueller

The 2000s cycle

Demand: The first decade in the new millennium began with office occupancies hitting their peak in the fourth quarter of 2000. Unfortunately office demand in 1999 and 2000 were higher than the long term U.S. trend, due to the growth of the technology industry. The speculative bubble in the stock market gave capital to tech companies who grew quickly, causing them to hire more employees and project their future space demands at unrealistic levels. The U.S. ended a long economic

expansion in 2001 after the tech bubble burst. Annual office employment declined for the first time by over -1% in 2001, while office demand (absorption) declined by over -2% as firms with excess space put that space on the sub-lease market in an attempt to rent unused space to other users and reduce their costs. This demand driven downturn was different from the supply driven down cycles of the 1970s and 1980s creating a new challenge for researchers. National office employment has always been positive in past cycles, while negative net absorption has been caused by too much supply. Office supply did react quickly, declining to very low levels and allowing the market to bottom quickly and begin a recovery in 2003.

Office employment has grown from 2002 to 2006 and is expected to grow over the next decade. Some of the major reasons for this continued growth include increasing demand from a globalized economy, continued technology revolution, and long term population growth. Population growth at just under 1% per year on a 300 million U.S. base translates into 2.5 million new people per year in the U.S., each year, for the next ten years. These additional people (half immigrants and half new births net of deaths) still need additional real estate to work in, shop at, sleep in, eat at, and play in. This means the U.S. will need to build one complete new city like Denver, or Phoenix each year for the next 10 years to meet space demand. While there may be small periods of recession, the long-term prospects are positive. In this cycle office employment increased by only 1.2% in 2004 and 1.4% in 2005 with a 5 year forecast of 1.5% going forward. Overall office demand (absorption) is expected to follow similar but slower growth rates of 1.3% over the second half of the 2000's decade. (Exhibit 4) With a flourishing economy, office demand growth is expected to average around 2% in the first half of the century.

Supply: Construction starts for office declined each year for the first half of the decade, declining each year to make up for the negative demand in 2001. The supply forecast average for the second half of the 2000 decade is estimated to be only 1.3% allowing occupancies to improve. (Exhibit 4) There are three principal reasons for this forecast:

1 - Public Capital Markets
With **public market monitoring**, it will be much more difficult to justify new space without an analysis of existing competitive construction and user demand for existing space. We have already seen the public capital market reaction to potential excess supply in cities like Atlanta where many new office construction projects were stopped in 1998 when Wall Street analysts downgraded REITs and Commercial Mortgage Backed Securities (CMBS) issues that were investing in the Atlanta office and industrial markets. New office supply in Atlanta dropped from 6.4 million square feet in 1998 to 5.9 million square feet in 1999. One Atlanta-focused REIT, Weeks Corporation, experienced a 20% stock price decline when news of Atlanta oversupply was revealed in the financial press. This monitoring by the capital markets let the Atlanta market move back into balance within a year's time, instead of going through an overbuilding boom bust cycle.

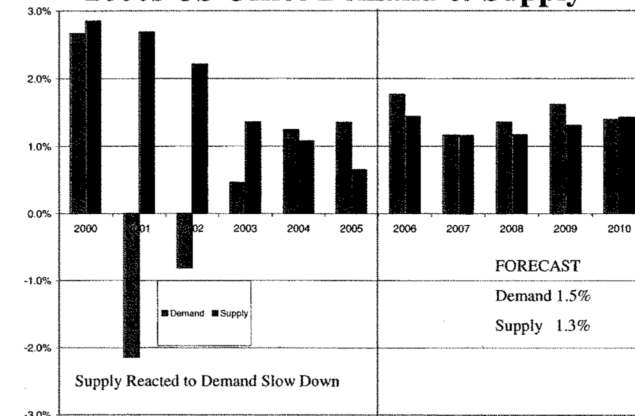
The **information feedback loop** that is now in place is much more likely to avoid large boom bust cycles in the future, as supply will be constrained by the wider availability of market information. The REIT market saw prices fall in 1998 and 1999 when direct markets were good and the outlook was even better, because the public capital markets were more attracted to high-tech stocks. On the other hand, the CMBS market brought more capital than traditional real estate debt lenders and many feared it would support non-economic projects. But in mid-year 2000, the REIT market recovered as the tech market fell and improved in both 2001 and 2002, showing that an earnings growth focus may be correct over the long term after all. The CMBS market has performed well from 2000 through 2006 with a focus on pre-leasing and tenant credit instead of property value.

2 - Construction Constraints
Constraints on building have increased over the past decades. The number of studies and approvals necessary for new construction has tripled in cost and time, over the past two decades. Environmental impact studies, traffic impact studies, storm water runoff management and other societal impacts must now be analyzed and mitigated before development approvals are given. While F.W. Dodge economists and data providers wrote about this lengthening, they were not able to prove it as the company only began keeping historic data in 1994, all previous data gathered was discarded on a regular basis. The cost of construction labor and materials has increased at high rates and construction labor was the hardest labor force in the country to find in 2000 and the first half of 2001. Therefore producing new supply takes longer and is more expensive. Development is now much more difficult than it was in previous cycles due to the up-front costs mentioned above. Many of the major developers have become long-term investors as well, by turning their companies into REITs. Capital partners for developers are now much more sophisticated than they have been in the past, requiring feasibility studies and pre-leasing prior to funding approval.

3 - Greater Transparency
The real estate markets and their cycles are much more transparent than they were a decade ago. In 1990 there were a few small firms collecting market data on 20 to 30 MSAs and selling it to a few large institutional investors. Over the decade more than 30 market research firms have been started and recently they have been consolidated into a few **national firms that cover as many as 60 major markets** in the U.S. in the five major property types. The largest firms are F.W. Dodge (who recently merged their data products with Torto Wheaton Research), Torto Wheaton Research (a Division of CB

Richard Ellis), CoStar (a national commercial multi-list system that has gone public and purchased four other firms), Grubb & Ellis, Property & Portfolio Research and REIS Reports. These firms provide general market information free to the general public and detailed data and trends to paying clients. With this information the multitude of research groups at private and public investment firms and banks are able to monitor the supply risks of each market and property type as well as forecast future potential investment opportunities. The availability of this research has made the real estate capital supply chain more efficient and less prone to making oversupply mistakes. Thus market transparency should make the next real estate cycle longer and less volatile.

Exhibit 4



Source: FW Dodge, CB Commercial, BLS, PPR, Mueller

Space Market Conclusion

The real estate cycle of the new century has already proven to be different with its demand driven downturn, but surprisingly quick reaction of supply to slow as well. This supply demand balancing should produce a longer and more moderate cycle for commercial real estate in the future. Having more stable occupancy rates should also produce more moderate but stable rental growth in the future. The 1980s real estate cycle was driven by oversupply that was partially due to the private nature of real estate markets, the tax shelter driven investments and the lack of good data. The future real estate cycles should be more moderate due to restricted supply conditions and more rational capital markets that are led by better information, monitoring and feedback systems that come with public capital sources. Eventually this more efficient market may reduce the ability to capture superior returns from better proprietary information and arbitrage investing, but the stability will create less risk for investors and lenders. An increased length in the economic cycle should be reflected in the increased length of the real estate space market cycles. If the U.S. and world economic expansions continue for the next decade, the U.S. real estate cycle recovery that began after the 2003 cycle bottom should move into a growth phase in 2008 for all property types. The cycles for each of the 5 major property types (office, warehouse, retail, apartment and hotel) will move differently – as they have in the past. Each city will also move at different rates depending upon local demand and supply characteristics.

The quarterly **Market Cycle Monitor** research report is attached as Appendix A and a literature review as Appendix B.

Capital Market Cycles

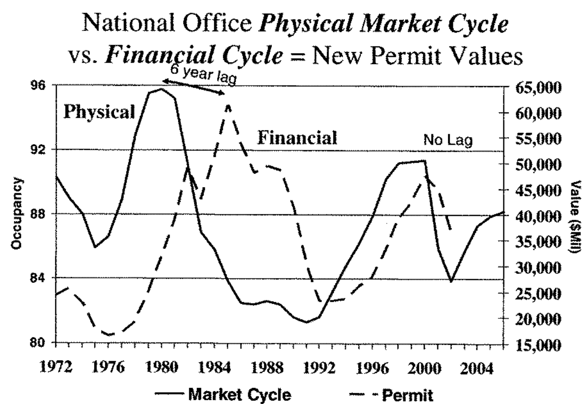
Historic Cycle Summary

Capital Flows are the major factor affecting prices in real estate as well as all other investments. When capital flows in, prices go up. The capital market cycles show that the public market was first tapped in a large way by real estate in the 1970s with mortgage REITs but this was a disaster because mortgage REITs were externally advised by their sponsor banks that did not care about the defaults in those portfolios as the bank's money was not at risk.

In the 1980s, the private real estate capital markets, driven by tax shelter investors, then non-taxable pension funds, then foreign investors created a long 10 year capital flow to real estate in the 1980s that created the largest overbuilding cycle ever experienced in the U.S. When the private capital markets turned away from real estate in the 1990s, the public markets were again accessed with new and improved REIT and CMBS vehicles that are still evolving. The 1990s were different though, because more information became available and the public markets began anticipating problems and not just reacting to them. This created a real estate market that maintained a balanced demand/supply growth in 1998, 1999 and 2000. There are many positives to the public capital markets including: access to public capital markets, better data, and accountability. There are also negatives to public markets such as stock price volatility, and competition for capital with other public market sectors (stocks and bonds). If economic and employment growth could be estimated accurately, there is a strong chance that real estate markets could estimate demand better and fine tune new supply even further than what has already been attained in the first half of the 2000's. The capital markets certainly seem to be making this demand – supply balancing act more accurate.

Capital cycles have historically lagged the space cycle. Capital flows continued to increase years after occupancies and rents declined in the 1980s. But in the 1990s the public markets helped to remove some of that lagged relationship and the physical and financial market cycles moved in sync when the downturn came in 2001. Exhibit 5 shows the historic movement of the office physical market and the financial flows of new capital supplied to office space construction. The lag in the early 1980s was about 6 years, but in 1991 the rebound only lagged by one year and in 2001 occupancy declines have created an immediate decline in new construction permits, thus the two cycles were moving together in similar patterns.

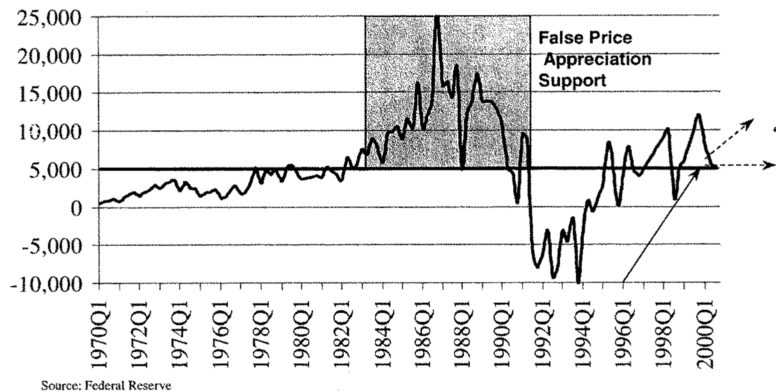
Exhibit 5



Capital flows are difficult to follow and even more difficult to predict as the whim of investors has not been captured in any known statistic. Current efforts by the Homer Hoyt Institute to study capital flows are funding research, such as the Real Estate Capital Flows Data Sources Project that can be found at www.Hoyt.org. The most notable and important source of capital flows data now comes from Real Capital Analytics, a firm started in 2000. The debt side of real estate is characterized here by commercial mortgage originations. Exhibit 6 shows the mortgage originations from 1970 through 2000. The late 1970s and early 1980s produced an average $5 billion in mortgage originations per quarter. In the second half of the 1980s the origination level rose to a peak $25 billion in one quarter (that is 5 times the normal average) and

stayed above the $5 billion level through 1990. This oversupply of capital (the gray box) was one of the major factors in the false price appreciation support for real estate. In the first half of the 1990s originations were negative (foreclosures) and in the second half of the 1990s rates returned to the average $5 billion per quarter level. Also note that the quarterly amounts in the 1990s are more volatile than the early 1980s as the public markets now play a major role in originations. The question is – where will it go in the future?

Exhibit 6

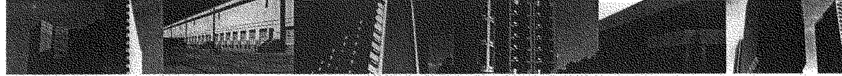


Source: Federal Reserve

Future Capital Cycles
Now that the public markets have emerged, real estate finally has access to the five major sources of the capital markets (public debt, private debt, public equity, private equity plus international capital). The new Public Capital sources developed in the 1990s (REITs and CMBS) have different effects, most of which appear to be positive on real estate and include better data, faster access to data, multiple monitoring and reporting sources, and better access to capital. This new era of public markets access and research oversight provides a feedback loop that should provide more balanced long-term capital flows as well as stability to the real estate markets. (REIT's low prices in 1998 and 1999 helped real estate markets avoid too much new development that would have been difficult to lease in 2001 and 2002.)

Conclusion
U.S. real estate capital markets have gone from being local in nature in the 1970s to national in nature in the 1980s to public and global in nature in the 1990s. The changing nature of all capital markets due to globalization makes the real estate capital markets more difficult to understand and predict. The poor performance of the stock and bond markets since 2000 has pushed much more capital toward real estate in the U.S. because real estate is now seen as a safer and more stable investment (A physical asset that can not evaporate into cyber space). It is also possible that this extra capital flow has moved U.S. capitalization rates (cash-on-cash return) from their historic 7% to 10% range down to the European range of 5% to 7% during the 2000s decade.

APPENDIX A



DIVIDEND CAPITAL®

Cycle Monitor - Real Estate Market Cycles

Second Quarter 2006 Analysis

August 2006

Physical Market Cycle Analysis of All Five Major Property Types in More Than 50 MSAs.

Construction costs continue to rise placing a damper on new starts. Through June, composite construction costs were up more than 8% for all commercial property types with plastic leading the way at 19%, copper at 14% and concrete at more than 11% year over year. This is very high compared to the consumer price index (CPI) of 4.3% over 12 months. Single family housing starts in June were down 11% over the previous year.

Office market occupancy average improved another 0.3% in 2Q06 and we expect 3% - 4% rental growth.

Industrial occupancy improved 0.2% in 2Q06, and we expect 2.5% to 3% rental growth for the year.

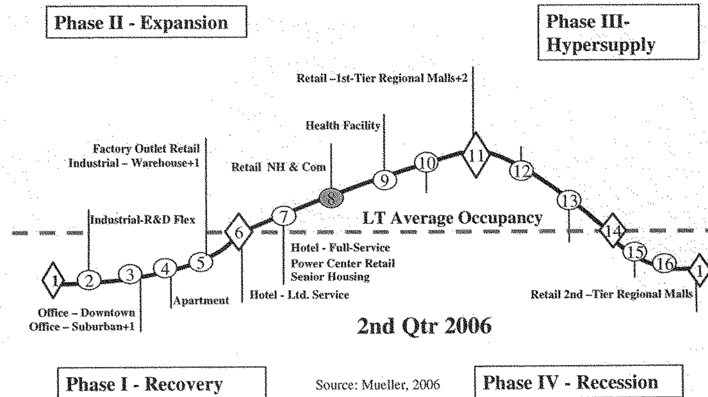
Apartment occupancy improved 0.2% in 2Q06, and we expect 4% rental growth for the year.

Retail occupancy improved 0.2% in 2Q06 and we expect 2% - 3% rent growth for the year.

Hotel occupancies improved 0.3% in 21Q06 and we expect RevPAR to grow by more than 10% for the year.

The National Property Type Cycle Graph shows relative positions of most subproperty types — major markets are reviewed inside.

National Property Type Cycle Locations



Source: Mueller, 2006

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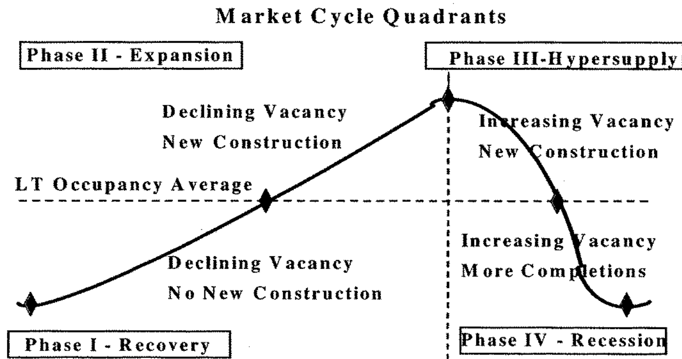
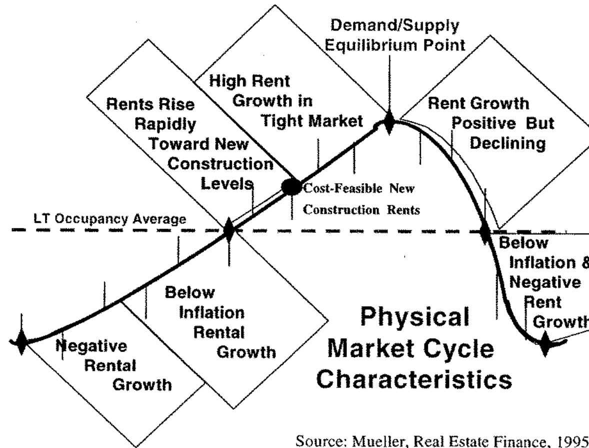
All relevant disclosures and certifications appear on page 9 of this report.

The cycle monitor analyzes occupancy movements in five property types in over 50 Metropolitan Statistical Areas (MSAs). Market cycle analysis should enhance investment-decision capabilities for investors and operators. The five property type cycle charts summarize almost 300 individual models that analyze occupancy levels and rental growth rates to provide the foundation for long-term investment success. Real estate markets are cyclical due to the lagged relationship between demand and supply for physical space. The long-term occupancy average is different for each market and each property type. ***Long-term occupancy average*** is a key factor in determining rental growth rates a key factor that affects real estate returns.



Source: Mueller, Real Estate Finance, 1995

Rental growth rates can be characterized in different parts of the market cycle, as shown below.

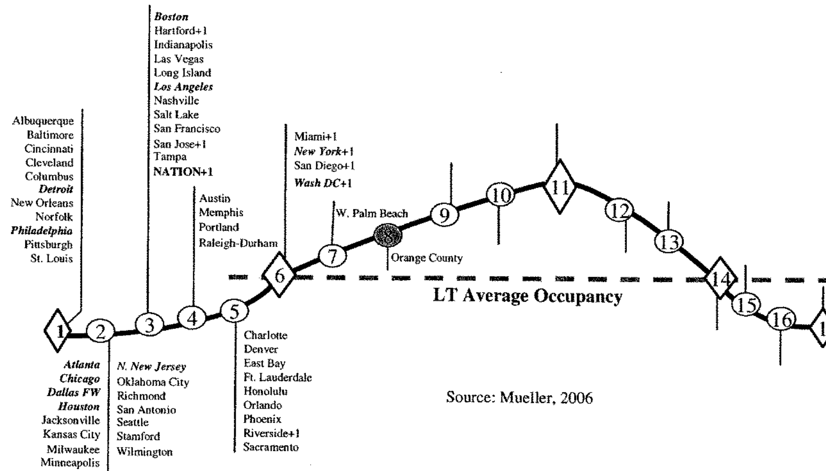


Source: Mueller, Real Estate Finance, 1995

OFFICE

The U.S. office market occupancy average improved another 0.3% in 2Q06 but is still 2% below the long-term average. Thus, it is still a tenant's market when negotiating new leases. The national average finally moved from position 2 to position 3 as we predicted last quarter. Net absorption for the quarter was more than 18 million square feet, and while new office construction is increasing, it is still half the rate of 2000. Occupancy improvement from 2Q05 to 2Q06 was a full 1% and different sources state that national average rents have increased about 3% to 4% over the past 12 months. We expect almost 1% increase in occupancy for the next year which can drive a 3% to 4% rent growth for the year.

Office Market Cycle Analysis
2nd Quarter, 2006



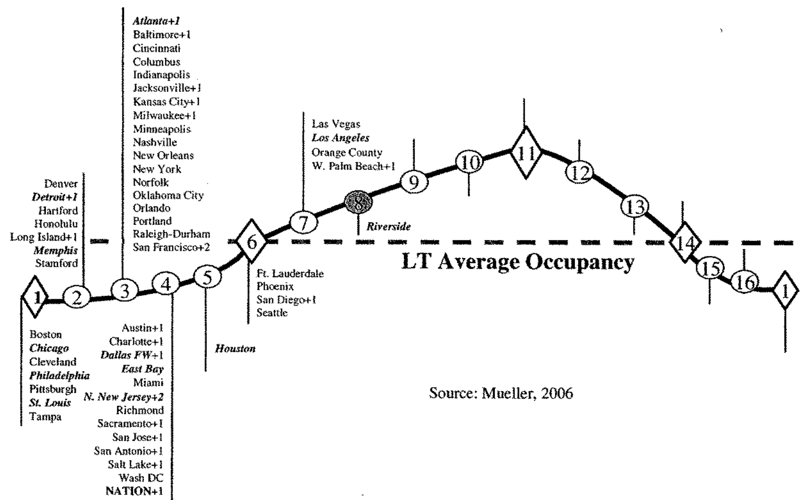
Note: The 11-largest office markets make up 50% of the total square footage of office space we monitor. Thus, the 11-largest office markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are now shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, i.e., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

Industrial

Industrial occupancy improved by 20 basis points in 2Q06, providing a 1.1% occupancy increase year over year from 2Q05. Eighteen cities improved their cycle position by at least one point, which moved the national average industrial cycle position to point #4 on the cycle graph. While new construction was strong at levels close to 2001, net absorption was almost 18 MSF for the quarter. Absorption continues to be strongest in southern California markets. Rents year over year were up 2.5% nationally. For the next year we expect another 0.5% occupancy increase which should drive rent growth in the 2.5% to 3% range.

Industrial Market Cycle Analysis
2nd Quarter, 2006



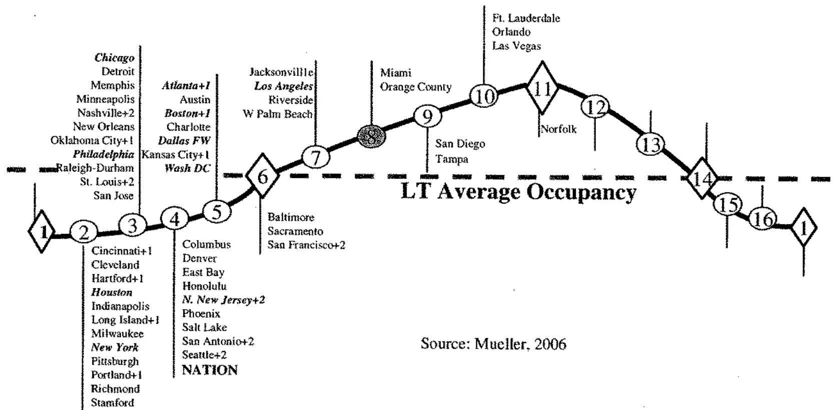
Note: The 12-largest industrial markets make up 50% of the total square footage of industrial space we monitor. Thus, the 12-largest industrial markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

Apartment

Apartment occupancy improved 10 basis points in 2Q06, this producing a 0.5% occupancy increase year over year. Multifamily construction starts were down 4% in the second quarter, 2% year over year and are hovering close to the long-term national average – which is sustainable. This shows moderation by the construction industry and reflects the decline in demand for condo conversions (the Condo craze is now over). Population growth and high housing costs still produce the best apartment markets. We anticipate occupancies to increase another 40 basis points in the next year. Rent growth was almost 3% year over year through the second quarter and we estimate 4% rent growth for the next year.

Apartment Market Cycle Analysis
2nd Quarter, 2006



Source: Mueller, 2006

Note: The 10-largest multifamily markets make up 50% of the total square footage of multifamily space we monitor. Thus, the 10-largest multifamily markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

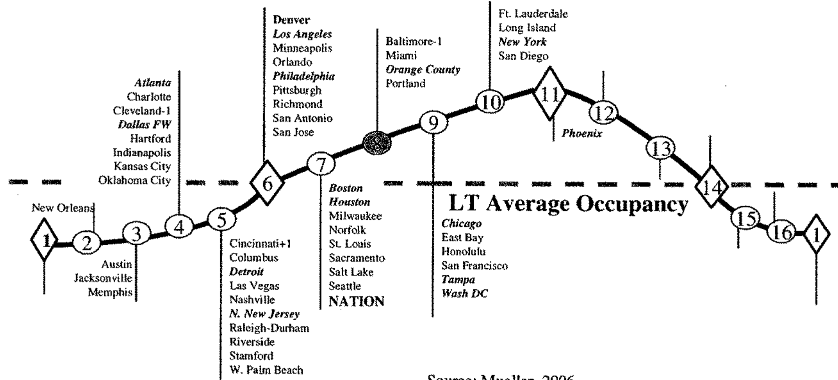
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

RETAIL

Retail occupancy improved 0.2% in 2Q06 but is up only 0.5% year over year. Consumer spending is now reflecting higher gas prices as the recent detailed consumer spending report showed people are spending more on books and less on electronic media; more on beer-groceries and less on restaurants; more on toys/games but less on sporting equipment and jewelry; more on personal care and less on home care. Regional mall occupancy appears to have peaked as it is hard to increase occupancy past 95%. Thus, mall rental growth will be the best of the retail property types. The national retail average remains in the growth phase, at position 7 on the cycle where it appears to be stabilizing, even with a slowing economy. We expect the national occupancy position to hold at this level for the year, and rental growth to moderate to the 2%–3% range over the next year.

Retail Market Cycle Analysis

2nd Quarter, 2006



Source: Mueller, 2006

Note: The 15-largest retail markets make up 50% of the total square footage of retail space we monitor. Thus, the 15-largest retail markets are in ***bold italic*** type to help distinguish how the weighted national average is affected.

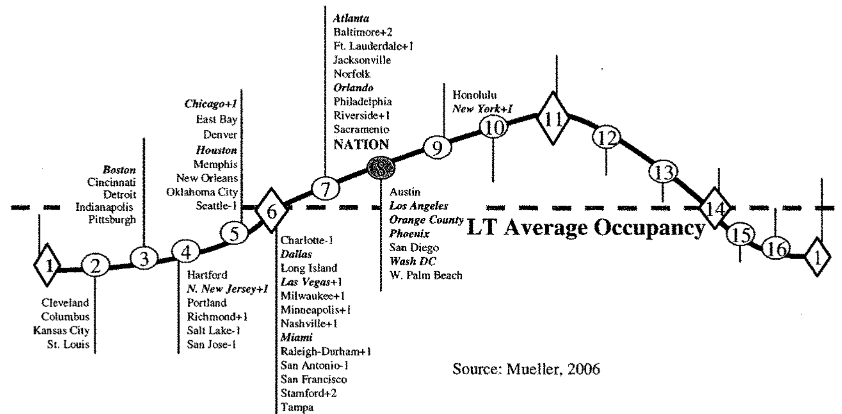
Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

HOTEL

Hotel occupancies improved 0.3% in 2Q06 and 1.2% year over year. Demand continues to be strong across the board with air travel up and most planes full. It is good news for the hotel industry that airlines have been able to become profitable in the face of higher fuel prices, but at the expense of few flight options for travelers. Construction starts have been very strong in many markets with Lodging Econometrics (www.lodging-econometrics.com) reporting a 50% year-over-year increase, which is a new high for this cycle, but about 15% below the peak set in 1998. Construction is highest in Washington, New York, Dallas, Los Angeles and Atlanta. Occupancy levels are now expected to improve another 1% over the next year, which would provide a RevPAR growth more than 10% in the next year as well.

Hotel Market Cycle Analysis

2nd Quarter, 2006



Note: The 14-largest hotel markets make up 50% of the total square footage of hotel space that we monitor. Thus, the 14-largest hotel markets are in boldface italics to help distinguish how the weighted national average is affected.

Markets that have moved since the previous quarter are shown with a + or - symbol next to the market name and the number of positions the market has moved is also shown, e.g., +1, +2 or -1, -2. Markets do not always go through smooth forward-cycle movements and can regress, or move backward in their cycle position when occupancy levels reverse their usual direction. This can happen when the marginal rate of change in demand increases (or declines) faster than originally estimated or if supply growth is stronger (or weaker) than originally estimated.

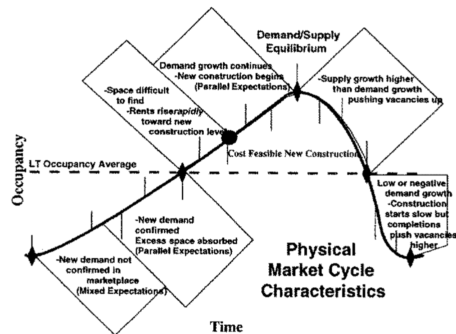
MARKET CYCLE ANALYSIS — Explanation

Supply and demand interaction is important to understand. Starting in Recovery Phase I at the bottom of a cycle (see chart below), the marketplace is in a state of oversupply from previous new construction or negative demand growth. At this bottom point, occupancy is at its trough. Typically, the market bottom occurs when the excess construction from the previous cycle stops. As the cycle bottom is passed, demand growth begins to slowly absorb the existing oversupply and supply growth is nonexistent or very low. As excess space is absorbed, vacancy rates fall, allowing rental rates in the market to stabilize and even begin to increase. As this recovery phase continues, positive expectations about the market allow landlords to increase rents at a slow pace (typically at or below inflation). Eventually, each local market reaches its ***long-term occupancy average*** whereby rental ***growth is equal to inflation***.

In Expansion Phase II, demand growth continues at increasing levels, creating a need for additional space. As vacancy rates fall below the ***long-term occupancy average***, signaling that supply is tightening in the marketplace, rents begin to rise rapidly until they reach a cost-feasible level that allows new construction to commence. In this period of tight supply, rapid rental growth can be experienced, which some observers call "rent spikes." (Some developers may also begin speculative construction in anticipation of cost-feasible rents if they are able to obtain financing.) Once cost-feasible rents are achieved in the marketplace, demand growth is still ahead of supply growth — a lag in providing new space due to the time to construct. Long expansionary periods are possible and many historical real estate cycles show that the overall up-cycle is a slow, long-term uphill climb. As long as demand growth rates are higher than supply growth rates, vacancy rates will continue to fall. The cycle peak point is where demand and supply are growing at the same rate ***or equilibrium.*** Before equilibrium, demand grows faster than supply; after equilibrium, supply grows faster than demand.

Hypersupply Phase III of the real estate cycle commences after the peak/equilibrium point #11 — where demand growth equals supply growth. Most real estate participants do not recognize this peak/equilibrium's passing, as occupancy rates are at their highest and well above long-term averages, a strong and tight market. During Phase III, supply growth is higher than demand growth (hypersupply), causing vacancy rates to rise back toward the long-term occupancy average. While there is no painful oversupply during this period, new supply completions compete for tenants in the marketplace. As more space is delivered to the market, rental growth slows. Eventually, market participants realize that the market has turned down and commitments to new construction should slow or stop. If new supply grows faster than demand once the long-term occupancy average is passed, the market falls into Phase IV.

Recession Phase IV begins as the market moves past the long-term occupancy average with high supply growth and low or negative demand growth. The extent of the market down-cycle will be determined by the difference (excess) between the market supply growth and demand growth. Massive oversupply, coupled with negative demand growth (that started when the market passed through long-term occupancy average in 1984), sent most U.S. office markets into the largest down-cycle ever experienced. During Phase IV, landlords realize that they will quickly lose market share if their rental rates are not competitive; they then lower rents to capture tenants, even if only to cover their buildings' fixed expenses. Market liquidity is also low or nonexistent in this phase, as the bid–ask spread in property prices is too wide. The cycle eventually reaches bottom as new construction and completions cease, or as demand growth turns up and begins to grow at rates higher than that of new supply added to the marketplace.



Source: Mueller, Real Estate Finance, 1995

This Research currently monitors five property types in more than 50 major markets. We gather data from numerous sources to evaluate and forecast market movements. The market cycle model we developed looks at the interaction of supply and demand to estimate future vacancy and rental rates. Our individual market models are combined to create a national average model for all U.S. markets. This model examines the current cycle locations for each property type and can be used for asset allocation and acquisition decisions.

Important Disclosures and Certifications

I, Glenn R. Mueller, Ph.D. certify that the opinions and forecasts expressed in this research report accurately reflect my personal views about the subjects discussed herein; and I, Glenn R. Mueller, certify that no part of my compensation from any source was, is, or will be directly or indirectly related to the content of this research report.

The information contained this report: (i) has been prepared or received from sources believed to be reliable but is not guaranteed; (ii) is not a complete summary or statement of all available data; (iii) is not an offer or recommendation to buy or sell any particular securities; and (iv) is not an offer to buy or sell any securities in the markets or sectors discussed in the report.

The opinions and forecasts expressed in this report are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of individual investors. Any opinions or forecasts in this report are not guarantees of how markets, sectors or individual securities or issuers will perform in the future, and the actual future performance of such markets, sectors or individual securities or issuers may differ. Further, any forecasts in this report have not been based on information received directly from issuers of securities in the sectors or markets discussed in the report.

Dr. Mueller serves as a Real Estate Investment Strategist with Dividend Capital Group. In this role, he provides investment advice to Dividend Capital Group and its affiliates regarding the real estate market and the various sectors within that market. Mr. Mueller's compensation from Dividend Capital Group and its affiliates is not based on the performance of any investment advisory client of Dividend Capital Group or its affiliates.

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APPENDIX B

Literature Review

Real estate cycles were first discussed by Homer Hoyt in 1933 in his analysis of the Chicago marketplace. Since that time market cycles have received scattered attention over the years. Pritchett (1984) theorized that there is a national real estate market cycle, but the cycles for each property type were not coincident. He stated that supply growth and decline always lagged demand growth and decline, thus turning points in the top and bottom of any cycle could be determined when the supply growth and demand growth were moving in opposite directions. However, recognition of turning points was less useful to investors than anticipation of such points. He applied these ideas by stating that the most advantageous buying opportunities generally exist during late declining, bottom, and early rising portions of the real estate market cycle.

Witten (1987) stated that every city had its own property cycles which were unique in length (time) and degree of change (magnitude) and were dependent on the internal dynamics of each market. He also stated that new supply while being cyclical is somewhat more volatile than demand, since supply is often determined by the availability of financing rather than by market need. He also observed that markets seldom move as smoothly as the classically drawn curves, but instead move in "fits and starts" causing investors to hesitate and wait for clear signs as to market changes.

Brown (1984) described cycle modeling as a simplification of the complexities of reality which hopefully capture the crucial features of the economic sector or system being studied. He believed that time series should be used to determine the length and magnitude of cycles as it seeks to measure movement over time. Also the longer the length of time studied, the better the understanding of the cycle movement. A key to cycle research is the identification and removal of trend and seasonal components inherent in time series data. He concluded that if feasibility analysts, investment advisors, and principals or lenders are to give credibility to market cycle analysis, much more research needs to be done. There are currently no uniform measurement procedures available, making it difficult to agree on the length and magnitude of cycle movements. He concluded that the downside of market cycles creates extreme economic obsolescence, thus real estate professionals need to maintain the perspective of cyclical timing in their decision making.

Wheaton (1987) using a sample of 10 cities, estimated the national office market cycle to have a length of between 10 and 12 years. He found that each city had a turning point (peak or trough) in its own market cycle that was within one or two years of the combined average of the 10 cities. He studied the causes of market movement that made the office market cyclical. One of his findings was that the tenure structure of office leases was usually long-term (e.g. 10-15 years). His explanatory model found that expected employment growth was significant in determining cycle behavior thus creating an adaptive demand model (supply will react to increased demand with a lag) and concluded that supply responds more readily to the state of the economy (as developers adjust their expectations to general economic indicators such as GDP growth and interest rates) than to actual local demand. This adjustment can actually help curtail the magnitude of a cycle as GDP growth is more moderate than local demand growth. He concluded that both supply and demand respond to changes in the economy although supply is more responsive than demand.

Wheaton & Torto (1988) studied rent and vacancy rate cycles and found that there was a market rental adjustment mechanism that caused real office rents to drop approximately 2% annually for every percentage point of excess vacancy above the long-term average in the market. They also found that the average office vacancy rate was trending upward over the 1968 to 1986 time period studied. Probably due to the excessively high supply rates of the 1980s.

Pyhrr, Webb, and Born (1990a, 1990b) in two different articles compare typical trend models for real estate analysis with a theoretical cycle model based upon demand, supply and inflation inputs. They conclude that the timing of acquisition and disposition in the cycle can be very important to the overall return received from real estate investments. Pyhrr, Born, Robinson and Lucas (1996) compare traditional valuation methods against a model using cyclical assumptions including demand, supply, absorption, occupancy rates and rental rate differences between newly constructed and existing properties. They conclude that valuations with cyclical assumptions can dramatically alter valuation conclusions, but that a cyclical model may be a better indicator of investment value (long-term), than market value (one point in time).

Mueller and Laposa (1994 and 1995) discussed the difference between overall market and submarket cycles. Their research found that submarkets can move differently from the overall market cycle in the short run, but submarkets will typically trend with overall market movements in the long run, because the locational advantages of a submarket become appropriately priced in the marketplace over time.

Mueller (1995) stratified real estate market cycles into two distinct cycle types: first, a physical cycle that described only the demand, supply, and occupancy of physical space in a local market that affects rental growth and second, a financial cycle that examined the capital flows into real estate for both existing properties and new construction which affects property prices. This separation between physical and financial cycles helps to clarify earlier work that mixed many definitions and helps explain the lag that appears to exist between market occupancy and rental movements versus real estate prices.

Grenadier (1995) developed a theoretical option pricing model of how vacancy rates and rental rates interact. He hypothesized that there is considerable inertia from existing building owners to adjust rents and occupancy levels in reaction to changing economic environments (the owner's option to rent). He also attempted to explain the recurrence of overbuilding during periods of low occupancy, by proposing that the costs of re-leasing can make vacancy "sticky", because landlords may choose to wait for higher rental rates before leasing space and that long construction times coupled with the inability to reverse a construction start decision can cause too much new supply. He also modeled demand volatility and theorized that markets with greater demand volatility had a higher propensity to overbuild.

The economic literature addresses price dispersion under various search models. Butters (1977) postulated that a consumer's imperfect information is insufficient to support price dispersion. Others have shown that heterogeneity among producers explains price dispersion [Carlson and McAfee (1983), MacMinn (1980)]. Nitzan and Tzur (1991) show that price dispersion can exist even when fully rational economic agents on both sides are homogeneous. Fershyman and Fishman (1992) present a dynamic search model which accounts for cyclical patterns of prices and demand. Thus, the behavior, strategies, and expectations of landlords and search behavior of tenants at various points in the real estate cycle may be explained by search theory models and price dispersion theory when we examine the rent price distributions in real estate markets. Applications to real estate value pricing are more difficult as homogeneous expectations are difficult to apply to heterogeneous assets.

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Glenn R. Mueller, Ph.D.

Dr. Mueller is an internationally known expert in commercial real estate cycles. He has written numerous academic and professional journal articles on commercial real estate cycles that have been cited in numerous publications. Most recently his work was cited in an article authored by Thomas Murray, Senior Financial Analyst at the FDIC, which appeared in the Summer 2006 edition of FDIC Outlook. The article was entitled "CRE Credit Expansion Raises Portfolio Concentrations." Dr. Mueller's quarterly *"Market Cycle Monitor"* is used and quoted by most major industry sources.

Dr. Mueller is a Professor of Real Estate at Denver University's Burns School of Real Estate and Construction Management. He continues (since 2002) his visiting professorship at Harvard University teaching real estate cycles and capital markets classes. He also holds the Ernst & Young visiting professorship at European Business School. Previously he held an Endowed Chair at Colorado State University. From 1992 to 2005 he served as a professor for the Berman Real Estate Institute at Johns Hopkins University. He is presently a thesis advisor for the Berman Real Estate Institute at Johns Hopkins University, Harvard real estate program and European Business School. Dr Mueller is also the co-editor of the *Journal of Real Estate Portfolio Management.*

Additionally, he serves as the Real Estate Investment Strategist for Dividend Capital Group, a company with over $4 billion in public REIT and private real estate and investment funds. He chairs the investment committee there.

Dr. Mueller has 30 years of real estate experience, a B.S.B.A. from Denver University, an MBA from Babson College and a Ph.D. from Georgia State University.

Testimony

Of

Karen Shaw Petrou
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Before the

Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
U.S. House of Representatives
September 14, 2006

This panel has led the way in recognizing the critical importance of the Basel risk-based capital rules, starting the policy debate in early 2002 with the first Congressional hearings on the rules long before many in the industry realized their critical importance. I was honored to testify then to offer views on the rules at that early stage and am grateful again now to outline ways to modernize the regulatory-capital requirements governing U.S. financial-services firms.

Sad to say, much of what I will say today is what I said in 2002 and at several later hearings on the proposal in the House and Senate. For example, in 2002, I urged the regulators carefully to consider the competitive implications of their rules. The House Financial Services Committee has pressed hard on this point and the agencies are now paying heed to it, but I fear that many aspects of the most recent proposal still do not address ongoing problems raised by the unique nature of the U.S. industry. It is different in many key respects from other national financial-services regimes, and U.S. rules must thus be carefully tailored to reflect U.S. reality.

There is, though, one key difference between 2002 and now: the Basel risk-based capital rules – for better or worse – are final everywhere else but here. Thus, we no longer have the luxury of pushing for a better international Accord. That is now final, and banks around the world will start to operate under it in January of 2007. This means not only that internationally-active U.S. banks will operate under anachronistic capital rules that place them at a disadvantage and that put the banking system at risk – that would be bad enough. However, it also means that foreign firms may have an undue capital advantage with which to enter the U.S. and acquire banks and other financial-services firms. As I said before this panel in May of 2005, M&A by global firms here is fine if it's a fair fight. It isn't fine, though, if our domestic institutions are gobbled up by foreign competitors able to engage in "regulatory arbitrage" solely because we can't make up our minds on our capital standards.

What are the key U.S. financial-system realities that must be kept carefully in mind as new capital rules are finalized? Put very simply, they are:

- We are facing emerging financial risks, most notably in housing and mortgage markets. We can debate all day long if the housing "bubble" will burst or fizzle, but we know for sure that U.S. consumers are highly leveraged and are making use in unparalleled fashion of high-risk mortgage products. The current Basel I rules applicable to all U.S. institutions woefully under-capitalize high-risk assets, creating a regulatory incentive for banks to hold them. Getting the risk right in risk-based capital is not just an issue for model builders. It's a critical challenge to protect the FDIC and the economy more generally.

- In the U.S. bank regulatory capital rules cover only insured depositories and a subset of parent holding companies. We have a wide range of charter options, the consolidated supervised entity (CSE) importantly among them, that permit astute companies to pick and choose among the charters. Outside the U.S., almost all firms fall under the Basel rules, eliminating much of the competitiveness concerns critical in the U.S. The Basel rules as now finalized may be good, bad or indifferent, but they will apply with few distinctions outside the U.S., ensuring the proverbial "level playing field." We will have a most uneven one – with dangerous systemic-risk ramifications – if the final U.S. bank capital rules do not reflect our charter and supervisory diversity. The proposed operational risk capital standard is particularly problematic in our competitive and legal reality.

- We have a unique capital requirement, the "leverage" standard proposed now to continue under the Basel IA and II regimes. Advocates of leverage argue that it will counteract possibly risky drops in regulatory capital. However, the leverage standard, while providing false comfort, exacerbates the charter disparities noted above because it applies only to some financial-services players, not to all of them. It is, further, no panacea for the problems in Basel. This panel will well remember the thousands of banks and S&Ls that failed in the 1980s and early 1990s even as the leverage standard applied to each and every one of them.

- We have thousands of banks, savings associations and credit unions – not just the four or five big players that dominate most other markets. Initial plans simply to ignore all but the biggest U.S. banks in the Basel rules have rightly been shelved, but the current proposal still has unnecessary restraints on what size institution may choose which capital regime. Each insured depository and, when applicable, holding company should choose the rules it thinks are right for it, not have that choice defined by its regulators. Supervisors have full powers – actually expanded under the Basel proposals – to intervene and add more capital if they think an institution's choice is risky.

With these thoughts in mind, I offer and urge the following recommendations related to the Basel rules in the U.S.:

- First, we need to get our rules in place as fast as possible. If we can't make up our minds on the more complex issues, leave them aside and finalize at least the simpler, "standardized" sections of the rules (revised for U.S. mortgage and other issues as necessary) and the Basel IA requirements. As noted, the current Basel I rules encourage risk-taking because there is no regulatory capital penalty for it. A simple rewrite that better equates risk-based capital to risk is urgently needed, and debate over the fine points of these highly-complex rules should not deter action on their key points on which there is, in fact, broad general agreement.

- Second, we should not cling to the leverage standard in hopes that it will protect us from "undue" capital drops. I very much doubt that risk-based capital under Basel II would drop here in anywhere near the amounts suggested by the fourth quantitative impact study, which was based on top-of-the-cycle numbers and back-of-the-envelope estimates. Putting banks and their holding companies through all of the hoops and all the added expense of the Basel rules and then slapping the leverage standard atop them undermines the entire point and purpose of the Basel standards and – importantly – is far from the guarantee of safety and soundness hoped by those now pushing for retaining the leverage standard. It should be discarded – especially for holding companies – and regulators should rely on their own powers and market discipline to press banks that might consider unwise capital reductions to think again.

- Third, the U.S. rules should not include an operational risk-based capital (ORBC) standard. The Basel IA proposal rightly does not include this and it should similarly be omitted from the Basel II rules. While this will put the U.S. Basel II rules at still more variance with the international Accord, it is necessary because of the lack of any agreed-upon methodology or measurement systems for operational risk. Worse still, a focus on ORBC will distract both banks and supervisors from urgently-needed disaster preparedness and contingency planning – capital is no substitute for back-up systems and advance planning as was made all too clear after September 11 and Hurricane Katrina.

- Finally, we must make up our mind and move forward. All of the benchmarks, caveats, limits and questions in the Basel II rules create wholesale uncertainty about what capital rules will apply when to whom. As noted, U.S. banks operate in the real world of aggressive competitors at home and abroad. We have proposed imposing not only new risk-based capital standards, but also new powers for regulators to buttress these – Pillar 2 – and new disclosure standards – Pillar 3 – to enhance market discipline. Far too little attention has been paid in the current debate to these critical elements of the overall Basel framework – indeed, they are almost unmentioned in the current notice of proposed rulemaking. Rightly structured, however, these two additional pillars will give U.S. regulators all the tools they need to ensure that capital is right for each bank under their purview without forcing institutions into the one-size-fits-all leverage standard, benchmarks, and other constraints on Basel now under consideration.

In conclusion, Basel critics might wish none of this had started and the U.S. could just get back to Basel I as is. This is understandable given all the flaws in the initial proposal and all the problems to which regulators turned a deaf ear for so long. However, it is critical to remember that Basel I as is rewards risk-taking and the leverage standard as is will do nothing to constrain this. It is also vital to remember that major competitors at home and abroad are now or will soon come under a more risk-sensitive capital regime with no leverage standard. Each and every one of these firms is a major force to be reckoned with in the U.S. whether or not it chooses to become a bank under the Federal Reserve's domain or headquarter itself here.

Thus, Basel II is here like it or not. Charters will be selected and deals done based on it, like it or not. The longer U.S. banks are kept under Basel wraps, the fewer of them there will be under our traditional regulatory framework. The longer Basel I is in place, the riskier our banking system will be – leverage standards now have no meaningful impact on risk other than to encourage taking it. Unless Congress is prepared to rewrite our rules and force all banks – big and small – and all competitors under the same capital regime – a major challenge that would keep Congresses busy for years to come – U.S. banks cannot be the last ones allowed to come under modern, risk-sensitive regulatory capital standards.

EMBARGOED
until September 14, 10:00 am

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

September 14, 2006

Office of Thrift Supervision
Department of the Treasury

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Statement required by 12 U.S.C. 250:
The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

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

September 14, 2006

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.

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.

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

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.

Testimony of

Harris H. Simmons

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Financial Institutions and Consumer Credit

Of the

Committee on Financial Services

United States House of Representatives

September 14, 2006

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Mr. Chairman and members of the Subcommittee, my name is Harris Simmons. I am Chairman, President and Chief Executive Officer of Zions Bancorporation, and Chairman of Zions First National Bank, both of which are headquartered in Salt Lake City, Utah. I also serve as Chairman of the American Bankers Association ("ABA"), and am here today to testify on behalf of the ABA.

ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

Thank you for the opportunity to present the ABA's views regarding the ongoing efforts to implement the Basel II risk-based capital requirements, and regarding the proposed guidance concerning commercial real estate ("CRE") concentrations. The ABA appreciates Congressional oversight of the regulators' actions in both of these important areas. Recent proposals by the regulators, while well-intended, have the potential to reduce the availability of affordable credit, adversely affect competition among banks, increase risk, and add to the already heavy costs of compliance.

RISK-BASED CAPITAL STANDARDS—SUMMARY

The ABA has long supported a comprehensive approach to the regulation of risk-based capital that encompasses minimum capital requirements, supervisory review, and market discipline. The goal of the Basel II accord is to arrive at capital requirements that better reflect risk in a bank. However, the Basel II capital requirements as embodied in the banking agencies' ("Agencies") recently promulgated Notice of

Proposed Rulemaking ("Proposal" or "NPR") fall short of that mark. In my testimony concerning the capital rules I would like to make the following points:

- First, the advanced capital adequacy framework recently proposed by the Agencies is an inappropriately conservative implementation of the international Basel II accord that would place U.S. banks at a competitive disadvantage with banks in other countries and impose a suboptimal use of financial resources.

- Second, the Agencies should expedite contemporaneous review and revision of the capital rules for the entire banking industry in order to avoid competitive imbalances domestically.

- Third, the variety and complexity of the American banking industry call for a select menu of capital options in order to achieve the best match of effective capital standard with banking institution; a one-size-fits-all approach means a bad fit for most banks.

CRE GUIDANCE—SUMMARY

Turning to the guidance concerning CRE concentrations, imposition of an industry-wide guidance in response to concentrations that are occurring at only some banks may negatively impact the free flow of credit from all banks that engage in CRE lending in a safe and sound manner. In my statement today I would like to make the following points regarding the CRE guidance:

- First, blanket industry-wide CRE guidance is unnecessary and potentially harmful.

- Second, if the Agencies conclude that guidance on CRE concentrations is necessary, several changes should be made in order to avoid unintended negative consequences.

- Third, if applied, the guidance should be used as a tool to identify the need for further inquiry, not as a formula for increased capital and reserves.

The above points concerning Basel II and the CRE guidance are discussed in further detail below.

RISK-BASED CAPITAL STANDARDS

I. The Agencies are Diverging from the Basel II Standards to the Detriment of U.S. Banks.

The Agencies have chosen a more restrictive and prescriptive approach than that being implemented in other countries. The provisions to be applied to internationally active U.S. banks, along with additional limitations that slow implementation and prevent efficient allocation of bank capital, mark a divergence from the standards embodied in the internationally agreed upon Basel II accord.

Under the international accord, three options for approaching credit risk are permitted. These include the Standardized Approach, the Foundation Internal Ratings-Based Approach, and the Advanced Internal Ratings-Based ("AIRB") Approach. In the U.S., the Agencies have proposed rules that implement ***only the AIRB approach***, requiring the largest internationally active banks – the so-called "mandatory banks" – to abide by them.

The Agencies propose to implement the AIRB approach in ways that are more restrictive than those embodied in the international Basel II accord. For example, the Proposal requires a bank that sells loans from a single borrower at a discount of five percent or more to treat ***all*** other loans from the same borrower as being in default, regardless of the situation. Other international banks lending to the same borrower would ***not*** be subject to the same requirement. Not only does such provision create artificial differences among competing institutions, it also contradicts the intent of the AIRB approach under Basel II, which is to allow banks the freedom to develop their own internal ratings-based system.

Furthermore, the AIRB approach as proposed contains several limits that will prevent banks from realizing its potential benefits. These limits include the following:

- Retention of the leverage ratio, which is currently the binding constraint on mandatory banks with respect to minimum capital requirements. Implementing the AIRB approach, while simultaneously retaining the leverage ratio, will render AIRB minimum capital determinations meaningless at best and harmful at worst. Banks that are required to hold more capital than is justified by a risk analysis will have incentives to take additional risks, perhaps outside their areas of expertise, in order to earn an acceptable return on the excess capital.

- Phasing in the AIRB approach over a three-year period following implementation of the Basel II standards. U.S. banks will be limited during this phase-in period by "transition floors" that impose arbitrary minimum capital requirements. No other Basel II nation will employ such limitations, and banks around the world will have moved on to the AIRB system long before U.S. banks even begin.
- The Agencies' promise to make further adjustments to the capital rules if the aggregate capital of banks employing the AIRB approach decreases more than ten percent during the phase-in period. This would effectively guarantee that the benefits of the AIRB approach will not be realized.

The objective of the rulemaking should be to tie capital to risk. Banks do this every day, separate and apart from regulatory capital requirements. Mandatory banks will continue to base their business decisions on their own internal measurement systems. However, if regulatory constraints interfere with this process and impose less accurate requirements, most banks will be forced to run parallel systems. One system will be used to satisfy the regulator, while the other system – which is a better gauge of risk – will be used to run the bank. It will be disruptive and inefficient to operate in an environment of dueling capital standards.

As a result of what some have called the "cumulative conservatism" of the AIRB approach as proposed in the NPR, the industry is likely to realize few, if any, of the benefits that were anticipated at the inauguration of the Basel II exercise as offsetting the burdens of the more complex rule. Artificially high capital requirements, coupled with a costly compliance burden, likely will lead to one of three results. Some domestic banks will choose to shift operations abroad as much as possible in an attempt to use their capital more efficiently, reduce their compliance burden, and continue to offer the best prices possible for their services. Others will choose to comply with the U.S. rules and, as a result, labor under the burdens of unnecessary costs and inefficient use of capital. There will be a third group of banks, however, that will comply with the U.S. rules but take on riskier lines of business to optimize the capital that they are required to hold. Each of these outcomes is likely to cause the U.S. economy to suffer. By being too restrictive, the Agencies would effectively impose a regulatory tax that either would make U.S. banks less able to serve as an economic catalyst in the United States or prompt them to engage in inappropriate risk-taking solely to use the excess capital required by the regulation.

The adverse consequences of the AIRB as proposed in the NPR are not confined to the mandatory banks. A bank considering whether to "opt in" to the adoption of the proposed AIRB likely

would find the benefits far outweighed by its burdens. Hence, the Basel II goal of encouraging superior risk management will be undermined.

These detrimental effects of the AIRB as proposed can be avoided if the Agencies adopt instead an AIRB that more closely follows the international Basel II accord. By making the capital rules that apply to U.S. banks comparable to those adopted in other countries, the competitive disadvantages that are hardwired into the current U.S. proposal would disappear, and banks domestically would have regulatory capital that is a much better match for their risks.

II. The Agencies should expedite contemporaneous review and revision of the capital rules for the entire banking industry in order to avoid competitive imbalances domestically.

If the Agencies were to adopt advanced capital rules comparable to those of the international Basel II accord, this would result in lower capital charges in many instances for the mandatory banks and opt-in banks (collectively, "Basel II banks"). Taken by itself, however, that would leave much of the rest of the banking industry subject to admittedly out-of-date capital standards. As a result, the vast majority of U.S. banks could find themselves at a disadvantage when competing with a Basel II bank for a particular asset. Evidence from the Quantitative Impact Studies indicates that Basel II banks could have significantly lower risk-based capital requirements for good credits, even after accounting for operational and other risks. Such banks would be able to make the same loan as community and regional banks, but at a fraction of the risk-based capital assessment. This would allow a Basel II bank to compete more aggressively for a given asset and it would free up capital for such banks that may be used to acquire more assets.

It is imperative that the Agencies not create winners and losers based on how much capital a given bank must set aside for a particular asset. To maintain competitive balance within the American banking industry, an appropriate update of capital rules is needed for all the community and regional banks for which the more advanced elements of Basel II are excessively expensive and complex. Each of these rules should require roughly the same amount of capital for the same asset, regardless of the size or sophistication of the banks involved.

The original Basel Accord was developed more than fifteen years ago to provide a uniform international regulatory standard specifically for large, internationally active banks. The Agencies, however, elected to apply it to every bank in the country. The generic model has never been a good fit for the wide variety of individual circumstances of American banks, particularly the smaller institutions. Customization, we were told, was out of the question, since the rule was developed through international

collaboration. With multinational adoption of Basel II, the existing-risk-based capital regime has become an archaic, idiosyncratic U.S. standard. In profound irony, it will be applied chiefly to the banks for which it was not intended, those that are not in the ranks of the largest or internationally active institutions. This misappropriation of capital standards needs to be addressed.

We congratulate the Agencies on their announced commitment to develop a revised version of the existing capital standards, sometimes called a Basel I-A. We compliment the Agencies on their plan to expedite the schedule for proposing alternatives to the Basel II capital rules so that they can be reviewed contemporaneously with the review of the current NPR. The mandatory banks have been working on their Basel II conforming systems for years. If the revised risk-based capital rules for all other banks are applied sequentially to the Basel II AIRB program, then the institutions adopting the AIRB standards will be ready to take advantage of their new paradigm while all others will be just beginning to adjust to theirs. These second-stage banks would, as an unintended result of regulatory action, surely lose customers and business to their larger rivals. Therefore, the Agencies need to move forward expeditiously to revise the general risk-based capital standards that will apply to banks not adopting the Basel II AIRB approach. This way the entire industry can be prepared to follow standards that are competitively comparable.

Moving up the existing risk-based capital standard revision schedule will also help with acceptance and implementation of Basel II. Accelerating the revision of the rule for the entire industry together would help allay competitive balance concerns voiced in the industry and by governmental leaders and reduce resistance to finalizing Basel II.

III. The variety and complexity of the American banking industry call for a select menu of capital options in order to achieve the best match of effective capital standard with banking institution; a one-size-fits-all approach means a bad fit for most banks.

Changes to the Proposal could make the AIRB approach a workable, effective means for determining how much capital is appropriate for the adopting banks. The ABA intends to submit detailed comments to the Agencies that will focus on changes we believe should be made to the "transitional floors," to the continued application of the leverage ratio, to the definition of "default," and to other areas where the regulators have taken what we consider to be unnecessarily restrictive positions. These changes would conform the AIRB for U.S. banks more closely to the AIRB as set forth in the international Basel II accord. If the problems highlighted during the comment period can be resolved, we would support adoption of the AIRB as one option for banks to consider.

In addition to addressing the problems in the AIRB approach, the Agencies should provide banks other appropriate risk-based capital options. This would include the Standardized Approach, as provided for in the Basel II accord. That approach ties capital charges to factors such as the credit rating of the borrower and the strength of collateral. It also recognizes that prudently underwritten residential real estate loans deserve a lower risk-weighting than is assigned under current rules.

While the Standardized Approach to credit risk is not as complex as the AIRB approach, it is nevertheless an improvement over existing rules and could be an optimal capital standard for many banks. For the mandatory banks it may be an appropriate balance of the benefits of greater risk sensitivity and the burdens of regulatory compliance. For banks considering whether to opt in to the Basel II framework, the Standardized Approach may present a better fit.

The Agencies also should continue their efforts to develop a "Basel I-A" approach that provides a meaningful option to the Standardized Approach. The current Basel I-A initiative was prompted by a recognition that existing capital rules are not sufficiently risk-sensitive for most banks but that the Basel II rules are likely to be too complicated. These concerns remain valid.

Many of the ideas discussed in the Agencies' Advance Notice of Proposed Rulemaking ("ANPR") concerning Basel I-A are potentially very helpful. These include such things as using more "risk buckets" when classifying assets and considering loan-to-value ratios when determining the capital charge for 1-4 family residential mortgage loans. However, given that no proposed rule has been published, it is impossible to offer views on particular changes to an existing regulation. If a Basel I-A proposal turns out to be largely the same as the Standardized Approach, we would encourage the Agencies to consider other options that would provide more flexibility when determining the appropriate amount of capital based on the quality of a bank's systems.

A fourth option should be to retain Basel I standards for banks with uncomplicated balance sheets. For many banks of this nature, the supervisory and paperwork burden of adopting a new system, even if it could lower the capital requirement, would not be an efficient use of resources. Hence, the existing Basel I rule is a prudent standard for many banks and should be retained as an option.

It is important that risk and capital be appropriately linked for all banks regardless of their size, and in such a way as to avoid creating competitive disparities. However, the efforts to improve the risk sensitivity of regulatory capital requirements should not result in disproportionate compliance burdens. Applying a select menu of reasonable capital standards for banks of all sizes is the best course of action. Just as applying the AIRB standards to small banks with uncomplicated balance sheets would

result in a bad fit, so too would continuing to apply the existing Basel I program for large, internationally active banks. That principle holds true, as well, for banks in the middle. One-size-fits-all is likely to be a bad fit for most banks.

CRE GUIDANCE

I. Blanket Industry-wide CRE Guidance is Unnecessary and Potentially Harmful.

The Agencies have proposed guidance concerning commercial real estate concentrations that could have serious unintended and adverse consequences. By using blanket industry-wide guidance to address concentrations that the regulators are seeing at "some" banks, the regulators risk choking off the flow of credit from banks that are engaging in CRE lending in a safe, sound, and profitable manner.

The guidance has caused both confusion and concern. The confusion stems from several factors. First, the guidance has been proposed at a time when the banking industry is exceptionally healthy, as evidenced by recent reports from the Federal Deposit Insurance Corporation and the Office of Thrift Supervision.[1] CRE loans in particular have performed exceptionally well, and have significantly outperformed commercial and industrial loans over the past decade.[2] Indeed, there is no indication that the guidance has been issued in response to widespread problems. In the preamble to the proposed guidance, the agencies note only that they are seeing concentrations at "some" banks. This does not warrant a conclusion that CRE concentrations are commonly found throughout the industry or even that they are *ipso facto* causing problems in the banks where the concentrations exist.

Second, there are significant differences between the banking industry of today and the industry of only a few years ago. For instance –

- Underwriting standards are better today, with more accurate appraisals, maximum loan-to-value ratios, and loan-to-one-borrower limits.
- The industry has significantly more capital today than before, and the regulators are statutorily directed to take forceful action when capital hits certain levels.
- Banks have better risk monitoring systems that catch problems quickly before they escalate.

[1] *See, e.g.*, FDIC Quarterly Bank Profile for the Second Quarter of 2006 (http://www2.fdic.gov/qbp/2006jun/qbp.pdf); OTS Thrift Industry Highlights for the Second Quarter of 2006 (http://www.ots.gov/docs/1/14620.pdf).
[2] *See* FDIC Outlook for Summer of 2006 (http://www.fdic.gov/bank/analytical/regional/ro20062q/na/2006_summer03.html).

- The combination of factors that led to the "perfect storm" that formed in the 1980s -- such as an oil market bust, very high interest rates, geographic concentration of bank assets, and a precipitous repeal of tax benefits -- is not present and has a low probability of repetition.

Third, the regulators have an ample supply of supervisory and enforcement tools at their disposal to address any bank that is failing to manage adequately the risks presented by a CRE concentration. This calls into question the need for industry-wide guidance. If, in fact, the regulators are seeing concentrations at only some banks, then the supervisory response should be tailored to fit the particular facts of a given bank.

Given the apparent absence of a problem that needs to be fixed, the ABA is concerned that the intent of guidance will be lost in its application. Examiners, eager to ensure that banks remain safe and sound and to avoid being second-guessed in the event problems arise in the banks they examine, understandably could construe an emphasis on CRE concentrations by Agency principals as a signal to crack down and direct a bank to take steps that are more conservative than the situation warrants. Indeed, some of our members have already experienced just that, as their examiners now appear to view concentrations as bad in and of themselves regardless of how well the concentrations are being managed.

There also is concern that the guidance is too blunt an instrument to address the particular issues affecting a given bank. The guidance uses a definition of "CRE loan" that is relatively new and, therefore, of undetermined value. However, by lumping many different types of loans together, the guidance fails to recognize that different types of CRE loans present different risks. For instance, a loan to build a multistory office complex will present very different risks from a loan to build 1-4 family homes. The guidance also fails to recognize that characteristics – and related risks – of loans within the same category will vary from loan to loan. Finally, the guidance does not account for the fact that resources vary from bank to bank and that risk mitigation steps that are used by one bank may be inappropriate for another.

These shortcomings have created concern that the guidance will make CRE lending too expensive for smaller banks to pursue. A burden that is not commensurate with risk will lead to inefficiencies that make this important line of business unprofitable for community banks. Banks will be forced to develop business outside their core competencies, thereby exposing the banks to risks for which they may be unprepared.

These problems are not confined to community banks. Even larger banks may find themselves being directed to put more aside in capital and reserves than safe and sound banking would otherwise

require. This could lead a bank either to underutilize the extra capital or use it in ways that increase the bank's risk profile as it tries to generate adequate returns on equity.

To avoid these outcomes, we have urged the regulators not to adopt the guidance but instead address problems on a case-by-case basis through the examination process and, if need be, enforcement actions. Clearly a bank with a CRE concentration needs to manage the risks of its CRE portfolio. Larger concentrations, of course, warrant greater attention. But a concentration in and of itself does not mean that greater care is not being given. The regulators already have every tool they need to address CRE concentrations where prudent care is not being given.

II. If the Agencies conclude that guidance on CRE concentrations is necessary, several changes should be made in order to avoid unintended negative consequences.

If the Agencies go forward with final guidance – which the ABA opposes – we have offered several suggestions for how to tailor the guidance better to the circumstances presented by today's banking industry. These suggestions are discussed in two letters the ABA has submitted on the proposed guidance, both of which are attached as appendices to this testimony.

Our suggestions highlight areas where the guidance needs to be refined to focus on concentrations more likely to be problematic. The broad and inclusive definition of CRE lending that is used in the proposed guidance is apt to lead to false alarms. The proposal focuses on sheer volume of loans secured by CRE without regard to mitigating factors, such as low loan-to-value ratios or guarantees. The guidance also lumps into the category of "CRE loans" business loans in which collateral interests in CRE are taken as additional security. By lumping so many different types of loans together, the guidance risks creating unfounded concerns that could adversely affect the supply and cost of credit.

III. The guidance, if applied, should be used as a tool to identify the need for further inquiry, not as a formula for increased capital and reserves.

If adopted in final form, the guidance should emphasize that it is not intended as a directive to require additional steps simply because a bank has a formulaic concentration. At most, it should be used as a tool identifying the need for further inquiry into the risk management practices of the bank. The examiners should consider requiring additional capital or reserves ***only after*** obtaining a full understanding

of the risks presented by a bank's portfolio and concluding that a bank is failing to manage those risks adequately.

The requested changes are consistent with the approach taken by the agencies in other contexts. For instance, the agencies stated in the Basel I-A ANPR that they "recognize that a 'one size fits all' approach to [acquisition, development and construction] lending might not be risk sensitive, and could discourage banking organizations from making ADC loans backed by substantial borrower equity." The agencies noted that they are considering different approaches to the risk-weighting of CRE loans based on factors such as the amount of borrower equity in a given project and whether a loan meets the Interagency Real Estate Lending Standards. The Basel I-A ANPR discussion on CRE concludes with a request for comment on "alternative ways to make risk weights for commercial real estate loans more risk sensitive. To that end, [the agencies] request comments on what types of risk drivers, like LTV ratios or credit assessments, could be used to differentiate among the credit qualities of commercial real estate loans, and how the risk drivers could be used to determine risk weights."[3] The ABA agrees that this is a very important question to consider, but not just in the context of capital standards.

CONCLUSION

The initiatives to improve existing capital rules and to address CRE concentrations, while distinct in many respects, share at least two things in common. First, each initiative could impose burden that far outweighs its benefit. Second, alternatives exist that would strike a better balance between costs and benefits than do the proposals under consideration. We appreciate the Agencies' willingness to consider alternatives, and we remain committed to working with the Agencies toward the goal of keeping the banking industry a safe, sound, and vibrant provider of financial services.

[3] ANPR, at 26-27.

ATTACHMENTS

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Re: **FDIC** (No docket ID); **FRB** Docket No. OP–1246; **OCC** Docket No. 05–21; **OTS** Docket No. 2006–01; **Proposed Interagency Guidance on Concentrations in Commercial Real Estate**; 71 Federal Register 2302; January 13, 2006.

Ladies and Gentlemen:

The Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision (the "Agencies") have proposed an Interagency Guidance on Concentrations in Commercial Real Estate ("Guidance") that raises the requirements for risk management by banks and savings associations that are deemed to have a concentration in commercial real estate ("CRE"). While not all commercial banks or savings associations are significantly involved in commercial real estate lending, a large number of them – including many community banks in particular -- are. For the reasons outlined below, this Guidance may well have significant adverse impact upon the banking industry and local economies. Accordingly, we recommend that the Agencies not issue it in its current form.

The American Bankers Association (ABA) appreciates the opportunity provided by the Agencies to comment upon the proposed Guidance. ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership--which includes community, regional and money center banks and holding companies, as well as savings associations, trust

companies and savings banks--makes ABA the largest banking trade association in the country.

General Comments

ABA has been informed that Agency staff consider the Guidance as largely reflecting existing real estate lending guidance from the Agencies. However, ABA staff discussions with member bankers reveal that many of our bankers see the Guidance as imposing significant new requirements on them as they engage in CRE lending. These bankers see the Guidance as raising serious concerns, which may be summarized as follows:

1. The new definition of a concentration in CRE combines several different types of CRE lending and establishes triggers for additional action without any attempt to distinguish the different levels of risk posed by each. This results in too many banks being deemed to have a high risk concentration in CRE.

2. Bankers will need to invest significant time, money, and effort to counter the assumption that they have an unsafe "concentration" of real estate loans. This is aggravated by confusing wording of the Guidance and the failure to reflect in the risk management practices differences in the size and CRE portfolios of different banks.

3. The Guidance strongly suggests that any bank deemed to have a concentration in CRE will be required to hold significantly higher levels of capital than other banks because of a conclusion that a large portfolio of CRE—as newly defined— is inherently riskier.

4. Similarly, the Guidance suggests that banks with large portfolios of CRE should have significantly higher reserves for loan losses. Such increased reserves should follow only if a portfolio in fact presents a higher level of risk.

5. The Guidance may significantly reduce community banks' ability to fund CRE in their communities, which will have a negative impact on the banks and their communities.

Recommendations

The Agencies should not issue this one-size-fits-all Guidance. Rather, ABA recommends that instead of imposing these new costs on the industry in general, the Agencies apply existing guidance on a case-by-case basis to address any problems in those banks not engaging in CRE lending responsibly.

If the Agencies do issue additional CRE guidance, then ABA urges that the Guidance be modified. First, it needs to focus on those institutions that are causing concern for the Agencies, namely, those institutions with a genuine high-risk concentration in CRE. Therefore, ABA recommends that the Guidance should not apply to loans that are clearly not high risk. For example, the carve-out in the Guidance of "owner-occupied" loans should include loans where real estate serving as collateral is subject to a contract for the construction and purchase of the property and loans made directly to the eventual owner of the house, as these are significantly safer than speculative building.

Second, the initial concentration limits are too low to justify the greatly increased scrutiny. ABA recommends that the initial screen should be raised to at least 200% of a bank's total capital.

Third, ABA recommends that the Guidance state more clearly how the specific requirements for management information systems and monitoring of the CRE portfolio may be scaled down for smaller banks and/or banks with narrowly focused CRE portfolios, such as primary residential housing construction.

Finally, ABA recommends that the proposed Guidance provide more detail concerning when higher levels of capital and/or of reserves would be required by examiners. The Agencies should not impute higher risk levels just on the basis of a finding of a concentration (as it is newly defined in the Guidance) in CRE lending but rather only on the basis of increased risk presented by the actual loans. It would be better if the Agencies addressed the needs for more capital or larger reserves on a case-by-case basis as part of the supervisory examination process rather than through an overly broad approach to reining in CRE lending. The finding of a concentration may suggest the need for closer review for risk but cannot replace the role of the supervisory examination process in identifying the actual presence of risks.

Analysis

1. Definition of a "concentration in commercial real estate lending"

Central to the application of the proposed Guidance is the definition of a "concentration in commercial real estate." This raises two fundamental issues: First, what is a "commercial real estate loan"; and second, what level of CRE lending represents a "concentration"?

(a) The definition of CRE

CRE is defined by the Agencies as –

> exposures secured by raw land, land development and construction (including 1–4 family residential construction), multi-family property, and non-farm nonresidential property where the primary or a significant source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property.

CRE also includes loans to Real Estate Investment Trusts (REITs) and unsecured loans to developers that closely correlate to the inherent risk in CRE. The Agencies exclude loans secured by owner-occupied properties from the CRE definition as having a lower risk profile.

This definition[1] melds various loans secured by commercial real estate into essentially one risk bucket, which ignores the very different risk profiles of some types of CRE-secured loans. First, there is no differentiation between (a) retail and office commercial real estate loans and (b) 1-4 family residential construction loans. Construction loans for income property pose significantly higher risks than 1-4 family construction loans.[2] Second, there is no differentiation between 1-4 family residential

[1] The Guidance begins with the definition of CRE; however, the definition of CRE is only used in the second threshold of 300% of capital to reduce the amount of loans that count towards it by allowing deduction of loans reported in the Call Report or Thrift Financial Report that do not fit the special definition of CRE in the Guidance.

[2] ABA notes that the currently prescribed capital treatment of 1-4 family construction loans (50% vs. 100% risk weight of other loans) and the higher allowed supervisory loan to value limit (85% vs. 80%) is an acknowledgment by the Agencies of the lower relative risk of this type of lending. However, such recognition of this lower risk appears to be absent in the proposed Guidance. It would be appropriate to acknowledge this in whatever risk threshold is included in the final guidance. A failure to do so will distort risk level comparisons made between peer banks.

construction that is built "on speculation" from 1-4 family residential construction where the contractor already has a contract for the house (a custom home contract). Losses on custom home contracts are very low and should not be in the same risk category as "spec housing."

The Guidance also inappropriately includes within the definition of CRE loans those loans that are made directly to consumers for construction of new housing. As we read the Guidance, the 100% threshold for a concentration of CRE does not treat these as owner-occupied. For some institutions, this type of lending is significant and its inclusion in regulatory guidance specific to CRE results in a significant distortion of the level of commercial construction risk relative to peer institutions. These direct-to-consumer construction loans are different from CRE because:

- These loans are generally originated for sale and underwritten to secondary market standards. The loans are classified as held for sale and generally sold to investors upon completion of construction.
- While there is construction completion risk, there is virtually no real estate market risk. The owner-occupants are responsible for repayment, and the loans are underwritten to permanent financing standards.
- Loans made directly to consumers are more appropriately considered consumer real estate loans instead of commercial real estate loans. The agencies acknowledge the lower risk in the former type of loan as the supervisory loan-to-value ratio limit for owner-occupied 1-4 family construction to permanent loans is 90%.

For all of these reasons, ABA recommends that the CRE definition be amended to distinguish clearly the risks between 1-4 family residential construction loans (particularly when they are "custom-built" loans or "owner-occupied" loans) and other commercial real estate loans. At a minimum, the Agencies should consider specifically excluding owner-occupied commercial real estate construction loans from the 100% threshold, in order to be consistent with the 300% threshold test for CRE, which acknowledges the fact that the risk profiles of these loans are less influenced by the condition of the general CRE market.[3]

(b) The appropriateness of the thresholds

The Guidance sets forth the following two supervisory thresholds, either of which may trigger greater scrutiny, greater risk management requirements, greater loan loss reserves, and greater capital:

> (1) Total reported loans for construction, land development, and other land represent one hundred percent (100%) or more of the institution's total capital. Institutions exceeding threshold (1) would be deemed to have a concentration in CRE construction and development loans and should have heightened risk management practices appropriate to the degree of CRE concentration risk of these loans in their portfolios and consistent with the Guidance.[4]
>
> (2) Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land represent three hundred percent (300%) or more of the institution's total capital. Any institution exceeding threshold (2)

[3] ABA notes that there are pending Call Report changes to schedule RC-C, line 1.e. that would facilitate the exclusion of owner-occupied commercial real estate loans form this calculation. If the Agencies continue with any Guidance, then ABA encourages the Agencies to use the new Call Report line item that excludes these loans when it becomes available.
[4] As noted above, the overly-inclusive definition of CRE does not distinguish between levels of risk of different types of lending identified as CRE by the Call Reports. If the Agencies decide to issue a revised Guidance, then we suggest that there be changes to the Call Report that allow better differentiation before defining such a threshold.

should further analyze its loans and quantify the dollar amount of those that meet the definition of a CRE loan contained in this Guidance. If the institution has a level of CRE loans meeting the CRE definition of 300 percent or more of total capital, it should have heightened risk management practices that are consistent with the Guidance.

Bankers are concerned about the relatively low threshold for determining when CRE concentrations present a higher risk. The Guidance sets an initial threshold of 100% of total capital for certain types of CRE. Previous limits on real estate lending set a threshold of 100% of total capital for loans secured by real estate **that were in excess of the supervisory loan-to-value ratio**. Total loans in excess of the supervisory LTV limits "for all commercial, agricultural, multifamily or other non-1-to-4 family residential properties" were also limited to no more than 30 percent of total capital.[5] As we understand the proposed Guidance, it is now possible for an institution to have **no** real estate loans over their appropriate LTV, yet trigger a presumed level of higher risk in CRE lending. This appears to be a significant shift in supervisory concern not clearly justified by the Agencies.

2. The burden on banks to counter the assumption of an unsafe concentration of CRE
After determining that the bank has a concentration of CRE under the new thresholds, the bank must ensure that it has "heightened risk management practices that are consistent with the Guidance." All of the bankers we have consulted agree that high levels of CRE require heightened risk management, and they believe that they do in fact have such risk management. However, few community banks have all of the revised recommendations for risk management practices in place, and none believes that all of the practices set forth in the Guidance are justified for the CRE lending that they are doing.[6] These banks are following existing real estate lending guidance, rather than this

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[5] See FDIC regulations at Appendix A to 12 CFR Part 365: Interagency Guidelines for Real Estate Lending Policies.

[6] The complete list of recommended risk management practices is extensive. It includes:

(1) Board and management oversight of the level of acceptable CRE exposures and implementation of a CRE strategy consistent with risk tolerance. "Directors, or a committee thereof, should explicitly approve the overall CRE lending strategy and policies of the institution. They should receive reports on changes in CRE market conditions and the institution's CRE lending activity that identify the size, significance, and risks related to CRE concentrations. Directors should use this information to provide clear guidance to management regarding the level of CRE exposures acceptable to the institution."

(2) Addressing the CRE strategy in the institution's strategic plan. Strategic planning should include "an analysis of the potential effect of a downturn in real estate markets on both earnings and capital and a contingency plan for responding to adverse market conditions."

(3) Instituting clear and measurable underwriting standards in its lending policy with only limited, documented, exceptions. Underwriting standards should include:

- Maximum loan amount by type of property,
- Loan terms,
- Pricing structures,
- LTV limits by property type,
- Requirements for feasibility studies and sensitivity analysis or stress-testing,
- Minimum requirements for initial investment and maintenance of hard equity by the borrower, and
- Minimum standards for borrower net worth, property cash flow, and debt service coverage for the property.

(4) Instituting policies specifying requirements and criteria for risk rating CRE exposures, ongoing account monitoring, identifying loan impairment, and recognizing losses. Risk ratings should be risk sensitive, objective, and tailored to the CRE exposure types underwritten by the institution.

(5) Identifying and managing concentrations, performing market analysis, and stress testing CRE credit risk on a portfolio basis.

(6) Maintaining MIS systems that are adequate go provide, on either an automated or manual basis, stratification of the "portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating. Institutions should be able to aggregate total exposure to a borrower including their credit exposure related to derivatives, such as interest rate swaps. MIS should maintain the appraised value at origination and subsequent valuations."

proposed Guidance that requires more detailed risk management practices and is aimed at institutions that actually pose higher risks in their CRE lending. There appears to be no attempt in the proposed Guidance to scale the regulatory response to the size of the bank or the particular composition of its portfolio. This creates a "one size fits all' approach inconsistent with recent regulatory initiatives in examination and supervision. For example, in the recent ANPR on Modifications to Domestic Capital Standards (Basel IA), the Agencies suggest that it would be appropriate to lower further the risk weight of home mortgage lending. But this Guidance includes direct-to-consumer mortgage construction lending as higher-risk CRE.

The Agencies state in the preamble to the Guidance that

> Recent examinations have indicated that the risk management practices and capital levels of **some** institutions are not keeping pace with their increasing CRE concentrations. In **some** cases, the Agencies have observed that institutions have rapidly expanded their CRE lending operations into new markets without establishing adequate control and reporting processes, including the preparation of market analyses.[7]

Thus, it appears that the proposed Guidance is meant to be focused on a few institutions. However, the way it is written suggests that examiners are to apply the Guidance with greater rigor to **all** institutions, not just the **some** that prompted the Agencies to propose the Guidance. We in fact already see this happening, as two of the bankers providing comment to ABA noted that their recent examinations involved much greater levels of scrutiny of the CRE and considerably more criticism of their risk management, even though neither felt that there had been significant changes in either their portfolios or their risk management practices since their last examinations.[8]

The extensive requirements set forth in the Guidance may be overwhelming for a community bank. Examiners will be asking for the bank's reports on market conditions, evidence of increased board oversight, production of new policies, more detailed strategic planning, quantifiable limits, contingency plans, feasibility studies, sensitivity analysis, stress-testing, tracking presales and more. Examiners clearly may apply this Guidance in a way that substantially increases the regulatory burden on community banks with limited staffs, and they may well feel that they are required to do so by the terms of the Guidance. ABA and our bankers believe that the application of the Guidance to all banks is excessive and that the full array of measures it requires should be reserved for those few banks that have problems in the risk management of their portfolios, whether CRE or any other concentration of lending.

All of these burdens likely will be compounded by the Guidance being unclear in several places. For instance, it is not clear whether the different thresholds for determining CRE concentrations require different responses. Under threshold (1), an institution "should have heightened risk management practices appropriate to the degree of CRE concentration risk of these loans in their portfolios and consistent with the Guidance." Under threshold (2), an institution "should have heightened risk management practices that are consistent with the Guidance." The key appears to be that under threshold (1), an institution must determine its degree of CRE concentration risk and then apply appropriate risk management practices. This may allow institutions to determine that they have a lower risk rate in their portfolios of 1-4 family residential construction loans or in direct-to-consumer loans than if they have a concentration in office construction. However, the Guidance is not clear

[7] 71 FR 2304 (emphasis added).

[8] One of the bankers stated, after reading the proposed Guidance, that he now understood what had happened in his recently concluded exam: the examiners were applying the draft Guidance to his institution before it had been published.

that banks may do this. This may lead to a heightened but uneven examination scrutiny of banks' risk management practices, as different examiners arrive at different judgments of an institution's "degree of CRE concentration risk" and require significantly different levels of risk management practices to similarly situated institutions.

The organization of the Guidance adds to the confusion. First the Guidance gives a special definition of CRE. Then the Guidance gives two different thresholds for a concentration in commercial real estate lending based on Call Report (or TFR) items that do not use the special definition of CRE. Then it provides that for threshold (2), but not for threshold (1), bankers should examine their loans reported in the Call Report using the new definition of CRE to reduce the amount of loans included in threshold (2). This is backwards. The special definition of CRE should follow the explanations of the thresholds, and be clearly shown to apply only to the calculation of the final amount for the 300% threshold. We have noted significant confusion from this structure of the Guidance.

The Guidance excludes "owner-occupied" properties from the final calculation of threshold (2), but the Guidance does not define "owner-occupied" and neither do the Call Report instructions.[9] This gives rise to a number of questions that will need to be resolved with the examiners. Is a loan to a contractor who is building the house under a contract for sale on completion "owner-occupied"? We believe it should be so termed. Are business premises that will be occupied by the owners but will also have commercial or even residential leases considered "owner-occupied"? Is it owner-occupied only if the owners occupy 25% or 50% or 75% or more of the building? Is it owner-occupied if the owners lease the premises to related companies of the owners? How closely do these companies need to be related to the owners in order for this to be owner-occupied? We believe that all of these questions could be answered in the affirmative, that these are still owner-occupied, but the Guidance is not clear on this.

ABA concludes that our bankers will need to invest significant time, money, and effort to counter the assumption that they have an unsafe "concentration" of real estate loans. This is aggravated by confusing wording of the Guidance and the lack of scaling of the risk management practices required to banks of different sizes and different CRE portfolios. We believe that the net effect of the Guidance as it is currently written will be excessive burden on community banks.

3. Increased capital requirements

A concentration in any line of lending requires greater risk management as the concentration in the line increases. However, community bankers tend to focus on one or two major lines of lending in order to be sure that they have the expertise on hand to manage the risk in that lending. The Guidance would appear to have the effect of penalizing banks – by requiring capital at levels that may be inappropriately high – that have focused their resources precisely to ensure that they can compete in a safe and sound manner.

Higher levels of CRE lending appear to be a logical evolution for community banks. As former Federal Reserve Board Chairman Alan Greenspan said in a speech in early 2004,

[9] An electronic search for the terms "owner-occupied" and "occupied" in the FFIEC Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041) found on-line at http://www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_041_200509_i.pdf located no use of the term of "owner-occupied" or its definition.

> Particularly noteworthy is the longer-term trend at community banks that seems to have accelerated in the past three years--the increasing share of asset growth accounted for by nonresidential real estate finance, particularly construction and land development loans and commercial and industrial real estate financing. Last year these categories accounted for more than 90 percent of the net asset growth of banks with less than $1 billion in assets; multifamily real estate and farmland finance would bring the total to more than 100 percent, offsetting the declines in other categories.
>
> Such credit exposures are a natural evolution of community banking and are quite profitable, helping to sustain both the earnings and growing equity capital of community banks. Moreover, the evidence suggests that community banks have avoided the underwriting mistakes that led to so many problems ten to fifteen years ago. Borrower equity is much higher and credit criteria are much stricter. In the last recession and during the early weak recovery, we saw very few delinquencies in these credits. Nonetheless, bankers need to be aware of the historical real estate cycle that, in the past, placed such exposures under severe stress. One hopes these improvements in underwriting standards are lasting. But the painful lessons of banking history underscore the ever-present need for vigilance in managing geographic and business line concentrations.[10]

Community bankers do not argue against the need for vigilance in managing geographic and business line concentrations. But they do argue against the arbitrary demand for additional capital that may result from the Guidance. Regardless of the intent of the Guidance, the risk is that the Guidance will lead to inappropriately higher capital levels. The Guidance states that –

> Minimum levels of regulatory capital do not provide institutions with sufficient buffer to absorb unexpected losses arising from loan concentrations. Failure to maintain an appropriate cushion for concentrations is inconsistent with the Agencies' capital adequacy guidelines. Moreover, an institution with a CRE concentration should recognize the need for additional capital support for CRE concentrations in its strategic, financial, and capital planning, including an assessment of the potential for future losses on CRE exposures.[11]

Our bankers unanimously read this as an instruction to examiners to demand more capital in the event that the examiner determines that there is a concentration in CRE. They see this as unrelated to how well the institution is managing its CRE portfolio, how low losses have been, what reserves have already been taken, and all of the other factors that should weigh on a determination of the need for additional capital. True, at the end of the discussion on capital adequacy, the Agencies state, "In assessing the adequacy of an institution's capital, the Agencies will take into account analysis provided by the institution as well as an evaluation of the level of inherent risk in the CRE portfolio and the quality of risk management based on the sound practices set forth in this Guidance." However, community bankers wonder if they can provide the kind of risk analysis that examiners will accept as mitigating this perceived higher risk. In short, bankers see this Guidance as a demand for higher capital at concentration levels that are really designed for triggering heightened risk management review rather than higher levels of capital.

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[10] Remarks by Federal Reserve Board Chairman Alan Greenspan before the Independent Community Bankers of America Convention; San Diego, California; March 17, 2004.
[11] 71 FR 2307.

The Agencies already have authority to demand higher levels of capital from any institution, if they determine that the institution has accumulated significantly higher risks than its peers or is otherwise acting in a manner that is inconsistent with existing guidelines.[12] Here the Guidance appears to move past that authority into creating an inherent need for additional capital for any concentration of CRE. Bankers believe that this sets far too low a trigger for requiring additional capital and ignores their current risk management practices. They urge that the Agencies drop this discussion of the need for additional capital and rely instead on existing authority, guidance and policies as the basis for a case-by-case determination of any need for additional capital.

4. Higher levels of reserves for loan losses

The Guidance appears to create a *per se* assumption that banks with large portfolios of CRE should have significantly higher reserves for loan losses because of a presumed greater level of risk presented by the CRE. However, many banks report little or no loss in their CRE portfolios, and they question the validity of singling out CRE for additional reserves. The Agencies, in the preamble to the Guidance, state that, "[i]n the past, weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system." But a point made repeatedly by bankers with whom we've communicated (and a point with which the Agencies apparently agree) is that banking today is different from what it was in the mid-eighties. We now have new capital requirements, more stringent real estate lending and appraisal requirements, express limits on high LTV real estate loans, and better supervisory examinations. As the Agencies note in the preamble, overall underwriting is better, largely due to the existing Agency guidance on real estate lending and the application of supervisory loan-to-value (LTV) ratios and limits on loans in excess of those ratios. Therefore, to blanket all banks with the requirements in the Guidance based on a newly crafted ratio, when there is no other evidence of weakness in capital or management, seems unjustified.

The assumption that there is a higher risk in a CRE portfolio ignores the risk presented by lending alternatives. Unsecured C&I loans, inventory financing, credit card lines, loans for consumer chattels -- none of these appear to be inherently less risky than CRE lending. Unlike these other types of loans, loans secured by mortgages on real estate will still have value in the property upon recovery even if the property deteriorates or the appraiser overestimated the property value. In even the worst case, only part of the principal will be lost.

By highlighting CRE and newly defining concentrations in CRE, the Agencies seem to be urging a higher reserving that previous guidance and policy do not appear to support. Worse, it may be at odds with recent guidance on reserving from the AICPA, which places the community bank squarely between its regulator and its auditors. At a minimum, this part of the Guidance needs to be clarified by better explanation of the connection of the Guidance to the existing Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.

5. Impact on small banks and their communities.

Finally, and most importantly, ABA is concerned about the probable impact of the proposed Guidance on small banks and their communities. Community bankers already find themselves unable to compete in various consumer lending businesses, lacking the scale to make credit card or auto lending profitable and sometimes unable to compete against the largest national mortgage

[12] See, e.g., Interagency Guidelines Establishing Standards for Safety and Soundness (stating that institutions should establish and maintain prudent credit underwriting practices that "(5) take adequate account of concentration of credit risk; and (6) are appropriate to the size of the institution and the nature and scope of its activities").

lenders. Many have become larger lenders in the CRE market as a natural evolution of the banking market, as former Chairman Greenspan observed. This willingness to support business expansion in their communities has been crucial to economic recovery over the last few years throughout the nation.

The implication in the Guidance that there will be major increases in capital requirements and loan loss reserves, as well as major additional demands on banks' officers and lending personnel to provide in-depth market analysis, stress testing analysis, and other analyses relating to possible negative effects of CRE concentrations, leads many banks to believe that they may well have to curtail significantly their CRE lending. As CRE lending has been one of few remaining major profit lines for community banks, they are deeply concerned about the negative impact of this Guidance on them and, consequentially, on their communities.

Conclusion

As community banks have been forced to consolidate lending due to national competition (in credit cards, mortgage lending and auto lending, as examples), local commercial real estate has been one of the strongest products for community banks. Their knowledge of their communities and markets affords community banks a significant advantage when competing for CRE loans. To have now stricter guidelines regarding commercial real estate imposed on *all of them* appears to increase the costs to all community banks making CRE loans while only peripherally addressing any problem banks.

Our discussions with staff of the Agencies lead us to believe that those consequences are not the intent of the Agencies, but it is the nature of lending Guidance such as this to result in a period of constriction while examiners and bankers work out new understandings of the instructions they have been given. Such a result will not benefit community banks or their communities, and it apparently is not what the Agencies intend. ABA recommends that the Agencies carefully reconsider issuing this Guidance and instead rely upon current guidance and policies during examinations to rein in those few banks that are causing the Agencies' concerns about CRE lending.

If the Agencies continue with issuing this Guidance, ABA strongly urges the Agencies to revise the Guidance thoroughly to eliminate the areas of confusion and concern that it has created for banks. Failing to do so would be a disservice to the Agencies' regulated institutions and to the communities these banks serve. If you have any questions about these comments, please call the undersigned.

Sincerely,

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August 1, 2006

The Honorable Susan Schmidt Bies
Governor
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

Re: Summary of Suggested Improvements to the Guidance on Concentrations in Commercial Real Estate (CRE), July 20 Meeting

Dear Governor Bies:

Thank you again for your participation in the recent meeting to discuss the proposed CRE guidance. Our members agreed with your assessments that the meeting was very productive, and we appreciate the opportunity to discuss the industry's concerns about the guidance. Following that meeting, we were offered the opportunity to summarize the suggestions offered at the meeting for ways to improve the guidance. Below is a summary of the major points advanced as well as other points that supplement the American Bankers Association's (ABA) comment letter dated March 30, 2006.

We note at the outset our continuing belief that it is more appropriate for the agencies to address problems with CRE concentrations on a bank-by-bank basis rather than issue a document that, because it applies industry-wide, necessarily risks being applied inappropriately at some institutions. If an examiner determines that a bank is failing to manage its CRE risks adequately, then clearly the agency should work with the bank to ensure that deficiencies are corrected. This is different, however, from suggesting (as guidance inevitably does) that there is a problem across the entire industry that the examiners must now fix. The latter approach risks inappropriately severe and procrustean responses by examiners to problems that do not exist.

If, however, the agencies conclude that guidance is necessary notwithstanding that risk, we offer the following suggestions for improvements to the guidance.

1. Of gravest concern to our bankers is the belief that the guidance may be interpreted as a direction to examiners, once a CRE concentration in the bank's portfolio of loans is found, to require a bank to take additional steps (perhaps including adding capital or refraining from making additional CRE loans), even if that portfolio is well managed. Subsequent discussions with the principals and senior staff of the Agencies reveal that this was not the intent of the Guidance. Our first suggestion, therefore, is to clarify in the guidance that CRE loans are not inherently riskier than other types of loans and that, if prudently managed, a bank may continue to make CRE loans notwithstanding the fact that the bank has a CRE concentration.

2. Related to the first point is a concern about the guidance being applied in a way that would automatically result in the imposition of additional CRE risk-monitoring or risk-mitigation steps, including additional capital and/or reserves for loan or lease losses. As discussed at our meeting, our members strongly believe that no regulatory response should be forthcoming without an adequate understanding by the examiners of how well a particular bank is managing its CRE portfolio. To impose additional burden on a bank without first determining that the bank is not properly managing the CRE portfolio is to a troubling degree like shooting in the dark and could be unnecessary, counterproductive, and harmful to the bank and its community. Thus, the guidance must underscore that any supervisory response will be calibrated to the facts presented by a particular bank.

3. The guidance must also reflect the fact that different banks have different resources and that what will be appropriate for one bank may be inappropriate for another. A community bank cannot be expected to have the systems, people, and processes that a regional or multinational bank has and may not need them for its particular situation and conditions. We appreciate acknowledgement of this fact in recent speeches by the agency principals,[1] and we urge that the final guidance contain a comparable acknowledgment.

4. Specifically in the context of the discussion of capital and reserves, the guidance should state that capital and reserves are appropriate topics for discussion only after the following:

- A concentration is found;
- The risk of the CRE portfolio is determined;
- Examiners conclude that the risk is not adequately managed;
- Examiners inform management of the inadequacies;
- The bank does not take steps to improve risk management within a reasonable time; and
- Examiners then determine that current reserves and/or capital are inadequate for the risk.

Requiring a bank to add capital and reserves in the absence of a demonstrated need either will adversely and inappropriately affect return on equity or force the bank to take additional risks, perhaps outside its area of expertise, in order to make efficient use of the additional funds. This could lead to more risk being driven into the banking system by the very requirement (*i.e.*, additional capital) that is intended to strengthen the industry.

5. The definition of "commercial real estate" for purposes of any final guidance should be rewritten. Currently, out of 44 pages of the Call Report, two-thirds of a bank's assets are lumped together on one line on Schedule RC-C. As discussed below, this raises concerns about the utility of the current definition and the need to narrow the definition of CRE loans.

Utility of the definition. The proposed guidance includes so many different types of loans within the definition "CRE" lending that it undermines whatever utility there is to identifying a concentration. The current approach includes residential construction, office construction, business expansion, and small business loans secured by real estate, all of which may exhibit considerable variability in risk, loan-to-value ("LTV") ratios, and market volatility. It is difficult to draw meaningful conclusions about the risks of a concentration when so many different types of loans –

[1] *See, e.g.*, Remarks by Governor Susan Schmidt Bies at the Mortgage Bankers Association Presidents Conference, June 14, 2006.

sharing only the common thread of being secured in whole or in part by commercial real estate – are lumped together. While the proposed changes to the Call Report[2] will partially help address this issue by providing additional granularity that may be used to identify problematic concentrations, until those changes are finalized the guidance is likely to create "false positives" where examiners conclude that a bank has greater risk from its CRE portfolio than the facts support.

Scope of definition. Even after the Call Report changes are finalized, the proposed definition of "CRE loan" inappropriately includes certain types of loans. This can be addressed only through changes to the definition. At a minimum, bankers believe that a definition of CRE for determining a concentration should exclude:

- Residential construction loans to consumers, which are risk-weighted at 50% for capital;
- Loans to builders on presold homes;
- Construction loans to entities that will occupy the building once it is completed;
- All 1-4 family residential rental property loans; and
- Loans with a low LTV ratio.

It may be possible to use a broad definition of CRE while taking the above CRE distinctions better into account in the risk assessment of the portfolio. That is, rather than exclude these types of CRE from the definition, simply provide guidance to examiners that these types of CRE may pose considerably less risk and will require less rigorous "risk management" because of the lower risk inherent in them. This appears to be particularly true of loans to consumers for 1-4 family residential construction, presold residential construction, and loans with LTV ratios of 50% or less. Indeed, as noted above, 1-4 family residential construction loans are viewed as such low-risk investments that they are risk-weighted under Basel I Capital Accord at only 50% and may be rated even lower in Basel II revisions to the Capital Accord.

6. The proposed guidance excludes "owner-occupied" property, but bankers found the definition of "owner-occupied" to be unclear. We note that the recent FDIC FIL-7-2006 contains a test for determining whether a property is "owner-occupied."[3] At a minimum, this explanation should be included in the guidance.

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[2] Several proposed changes to the Call Reports have been adopted, but on a staggered, delayed system, some in 2006, some in 2007, and some in 2008, largely dependent upon the size of the bank and the degree of concentration in CRE. The changes are as follows:

- Splitting "Construction, land development, and other land loans" (CLD&OL loans) into separate categories for 1–4 family residential CLD&OL loans and all other CLD&OL loans (Schedule RC–C, part I, item 1.a; Schedule RC–N, item 1.a; Schedule RI–B, part I, item 1.a; and Schedule RC–L, item 1.c.1);
- Splitting loans "Secured by nonfarm nonresidential properties" (commercial real estate loans) into separate categories for owner-occupied and other commercial real estate (Schedule RC–C, part I, item 1.e; Schedule RC–N, item 1.e; Schedule RI–B, part I, item 1.e); and
- Replacing the breakdown of "Lease financing receivables" between leases from U.S. and non-U.S. addressees with a breakdown of leases between retail (consumer) leases and commercial leases for banks with foreign offices or with domestic offices only and $300 million or more in total assets (Schedule RC–C, part I, items 10.a and 10.b; Schedule RC–N, items 8.a and 8.b on the FFIEC 031 and Memorandum item 3.d on the FFIEC 041; and Schedule RI– B, part I, items 8.a and 8.b on the FFIEC 031 and Memorandum item 2.d on the FFIEC 041).

[3] "'Loans secured by other nonfarm nonresidential properties'" are those loans that are currently reported in Schedule RC-C, item 1.e, where the primary or a significant source of repayment is derived from rental income associated with the property (i.e., loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property.

7. The guidance also needs to provide a clearer discussion of what agricultural loans are included within its scope. The proposed guidance has two concentration tests:

> (1) Total reported loans for construction, land development, and other land represent one hundred percent (100%) or more of the institution's total capital; or
> (2) Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land represent three hundred percent (300%) or more of the institution's total capital.

The proposed guidance states in the footnotes that item (1) above is "For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC–C item 1a." The Call Report instructions state that:

> Schedule 1.a Construction, land development, and other land loans. Report in column B loans secured by real estate made to finance land development (i.e., the process of improving land -- laying sewers, water pipes, etc.) preparatory to erecting new structures or the on-site construction of industrial, commercial, residential, or farm buildings. For this item, "construction" includes not only construction of new structures, but also additions or alterations to existing structures and the demolition of existing structures to make way for new structures.
> Also include in this item:
> (1) Loans secured by vacant land, except land known to be used or usable for agricultural purposes, such as crop and livestock production (which should be reported in Schedule RC-C, part I, item 1.b, below, as loans secured by farmland)....
> (Emphasis added.)

For the second test of a CRE concentration, the proposed guidance includes nonfarm nonresidential properties, as reported in the Call Report. This point is explained in footnote 4 of the proposed guidance as follows: "For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC–C items 1a, 1d, and 1e." 1b is loans secured by farmland and 1c is loans secured by 1-4 family residential properties.

The guidance leaves open questions such as whether a loan secured by land on which a farm building is constructed is included within within the definition of "CRE loan" and, if so, whether it is included for purposes of both concentration thresholds.. In order to achieve the agencies' goal of providing clarity about what is a CRE concentration, and in order to avoid any unintended consequences of discouraging farmland lending, the guidance must be clearer in its discussion of when farmland will be deemed to be within the scope of the guidance.

Thus, the primary or a significant source of repayment for 'Loans secured by owner-occupied nonfarm nonresidential properties' is the cash flow from the ongoing operations and activities conducted by the party, or an affiliate of the party, who owns the property, rather than from third party, nonaffiliated, rental income or the proceeds of the sale, refinancing, or permanent financing of the property. 'The determination as to whether a property is considered 'owner-occupied' should be made upon acquisition (origination or purchase) of the loan. However, for purposes of determining whether existing nonfarm nonresidential real estate loans should be reported as 'owner-occupied' beginning March 31, 2007, or 2008, banks may consider the source of repayment either when the loan was acquired or based on the most recent available information. Once a bank determines whether a loan should be reported as 'owner-occupied' or not, this determination need not be reviewed thereafter." (Emphasis added.)

* * *

As noted at our meeting, we very much appreciate the agencies' willingness to discuss the concerns of the industry and to make appropriate adjustments to the guidance to reflect those concerns. If the agencies decide that guidance is necessary (as opposed to dealing with problems on a case-by-case basis), then, given the substantial changes to the guidance that we recommend be made, we suggest the agencies republish the guidance in proposed form again so that the final product is likelier to strike the appropriate balance between benefit and burden. If, however, the agencies decide to publish a final guidance document as the next step, we suggest at a minimum, given the nonbinding, informal nature of guidance, that the agencies continue their dialogue with the industry about how the guidance is being applied and ways it may be improved going forward.

Sincerely,

Mark Tenhundfeld
Director, Office of Regulatory Policy

CC: Steve Fritts
Grovetta Gardineer
Martin J. Gruenberg
John M. Reich
Claude Rollin
Robert Russell
Barbara Ryan
Sabbeth Siddique
Mark VanDerWeide
John G. Walsh
Kurt Wilhelm

Testimony of

Robert M. White, Jr.

Before the

Subcommittee on Financial Institutions and Consumer Credit

Of the

Committee on Financial Services

United States House of Representatives

September 14, 2006

Evolution of the Commercial Real Estate Capital Markets and its Cycles

By
Robert M. White Jr.
President and Founder: Real Capital Analytics, Inc.

September 2006

Key Points

- The proposed banking agency guidance on commercial real estate lending concentrations appears to be predicated on fundamental misconceptions of how the commercial real estate market functions today.
- Today's commercial real estate market is very different from the one that existed in the late 1980s and early 1990s. Today's commercial real estate market benefits from greater transparency, increased scrutiny and more timely information associated with the growth in public Real Estate Investment Trusts and the creation of the Commercial Mortgage Backed Securities Market.
- The information feedback loop that is now in place should help prevent large boom bust cycles in the future.
- The definition of commercial real estate in the proposed guidance appears to be based on the misconception that the residential real estate market and commercial real estate market are sufficiently correlated to justify including certain types of residential real estate loans within the definition of commercial real estate.
- The commercial "for rent" and residential 'home ownership" real estate markets are distinctly different and move in different cycles.
- The commercial real estate capital markets have become a sophisticated national and international marketplace while the space, or leasing markets remain local.
- Equity capital for commercial property comes from a great diversity of sources, many of which did not exist in the 1980s.
- The commercial mortgage industry has been transformed by access to the public sector securities which now originates more loans than commercial banks using the commercial mortgage backed securities (CMBS) vehicle.
- Public equity (Real Estate Investment Trusts) and public debt (Commercial Mortgage Backed Securities) have revolutionized transparency and standards throughout the industry.
- Commercial real estate has emerged as the fourth asset class along with stocks, bonds and cash for a national and international investor base.
- It is unlikely that equity or debt capital will stop flowing to commercial real estate as it did in 1990 when the commercial real estate market crashed. The regulatory and private industry monitoring systems have created a check and balance system that is working well.

Purpose of This Written Testimony

Earlier this year, the federal banking agencies issued proposed guidance entitled "Concentrations In Commercial Real Estate Lending, Sound Risk Management Practices" (the "Guidance"). The proposed Guidance sets forth certain thresholds for assessing whether an institution has commercial real estate loan concentrations that would trigger heightened risk management practices and potentially higher capital requirements. After analyzing the proposed Guidance, it appears that it is predicated on fundamental misconceptions of how the commercial real estate market functions today. These misconceptions seem to be based on the assumption that this market has not witnessed fundamental changes over the last two decades. Simply stated, today's commercial real estate market is very different from the one that existed in the late 1980s and early 1990s. For example, the commercial real estate markets and their cycles are much more transparent today than they were a decade ago. This increased transparency allows investors, developers and lenders to react much more quickly to market risks and substantially reduces the potential for overbuilding. This increased market transparency should make future real estate cycles longer and less volatile.

The definition of commercial real estate in the proposed Guidance appears to be based on the misconception that the residential real estate market and commercial real estate market are correlated to such an extent that certain types of residential loans should be included within the definition of commercial real estate for purposes of the proposed Guidance. This is a faulty premise because the commercial real estate market and the residential real estate market are fundamentally different and move in different cycles.

Commercial real estate is a necessary and important part of economic growth. In order to avoid any potential unintended consequences, the bank regulatory approach to commercial real estate lending must be predicated on an accurate understanding of today's commercial real estate market environment. The purpose of this written testimony is to set forth the changes that have occurred in the commercial real estate market over the last two decades in order to address the misconceptions upon which the proposed Guidance appears to be based.

Defining the Markets

Capital vs Space Markets

In order to understand the cyclical nature of the real estate industry, it is important to differentiate the capital markets from the space, or leasing markets. Capital market factors concern such things as asset prices, liquidity, and mortgage rates. The space markets refer to leases, rental rates, and occupancy levels. The capital and space markets move in different cycles although each also influences the other. For example, in the 1980s, capital market factors, too much capital, lead to overdevelopment which in turn overbuilt and thus undermined the space markets. More recently, in 2001, the space markets suffered a demand shock, as high tech tenants evaporated almost overnight leaving considerable vacant space. However, at the same time leasing fundamentals were deteriorating, the capital markets for commercial property rallied, causing prices to rise. Investors, many burnt by the dot-com frenzy in stocks, were attracted to real estate because it is a tangible "hard" asset and it offered relatively high yields and significant portfolio diversification benefits. A new capital cycle began as large institutional investors and private individuals re-allocated capital from the stock market and into real estate.

The period from 2001 and into 2004 has often been referred to as "the disconnect" of the commercial real estate markets. The capital environment (price) was very positive and improving yet the space markets (occupancy) were weak and faltering. Currently, the leasing conditions for almost all property types and most markets nationally are improving and the capital environment remains favorable. The capital and space markets are once again moving in the same direction.

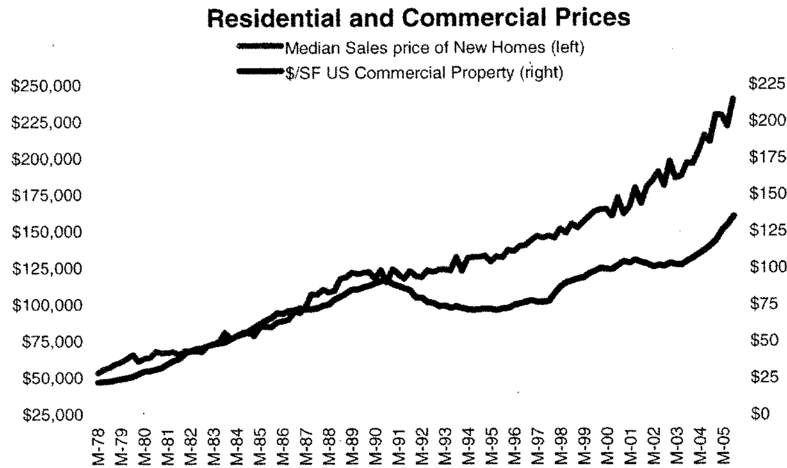
Local vs. National

The supply and demand factors that influence the space markets are specific to each local market where a property is located. The demand for space by tenants is determined largely by the strength of the local economy and the availability of space within that local market. By contrast, the capital markets have evolved into a national marketplace that is moving quickly toward globalization. Investors and bankers are no longer limited just to nearby markets, but are diversifying their portfolios by investing in opportunities in other markets, across regions and even offshore.

This free flow of real estate capital makes the capital markets more efficient and helps mitigate risks. For example, commercial property in California commands among the highest prices in the nation so some owners have recently decided to sell those assets at premium prices and buy property in markets that they perceive as cheap, such as Phoenix or Dallas or Atlanta. Over the past two years, the amount of real estate capital from California-based buyers has quadrupled. Only recently have the information and tools necessary to underwrite investments and operate in multiple markets become readily available. This information and tools were not available during the 1980s. Moreover, it is only since the Riegle-Neal Act in 1994 allowing interstate branch banking that banks have been permitted to diversify their mortgage portfolios geographically.

Residential vs Commercial Markets

A house and an office building are both considered real estate assets, yet both operate in entirely different capital environments and their economics are driven by entirely different supply and demand factors. A clear distinction between commercial and residential properties is made throughout the construction, lending, brokerage and investment industries as market participants have had to specialize to address the dichotomy of these two disparate classes of real estate. No longer can housing and commercial property be grouped simply as "real estate".

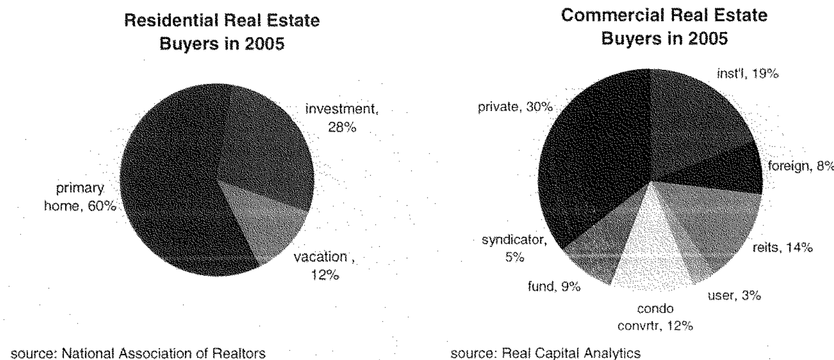


sources: NCREIF, NAHB

Over the past 25 years, prices for commercial and residential property have moved independently and have not shared the same "real estate" cycles. For example, between December 2000 and December 2003, the median price for a new home increased by 21%, yet the average price for commercial property increased by just 3% over the same period. Again, in a different economic period between 1989 and 1992, prices for commercial property fell 16% while housing prices

actually increased. Certainly, prices for all types of newly constructed real estate are affected by similar influences such as land and raw material costs, interest rates and the general economic climate, but ultimately prices for residential and commercial property are determined independently.

One reason the housing and commercial markets move in different cycles is that commercial property buyers encompass a diverse pool of capital sources (buyers/investors) beyond the private individuals that that own and live in housing. Institutional investors (pension funds and endowments), REITs, and foreign investors now represent almost half of all commercial acquisitions. Moreover, these investors tend to be low/no-leverage buyers making them less sensitive to rising interest rates than are other investors and most homebuyers. In addition, most commercial investors have a long-term perspective and buy and hold property for the income. In comparison, a speculator/flipper mentality has become pervasive in the residential market and their profits depend almost entirely on price appreciation. Residential buyers are generally also local in scope, but most commercial buyers are national if not international investors with greater freedom to invest without geographic limitations.



Equity capital for commercial real estate has evolved significantly over the past 25 years to include a diversity of public and private, domestic and foreign, and institutional and entrepreneurial sources. Prior to 1980, commercial property investors were similar in composition to home buyers in that the capital was largely private and local. While private investors still play an important role in the capital markets, the commercial marketplace is no longer dependant on them. In 2005, more sophisticated and better capitalized groups of buyers were responsible for 70% of commercial property acquisitions. The influx of these other capital sources has fundamentally changed the nature of the commercial marketplace since the 1980s and the diversity of capital has made it far less volatile.

Overview of the Commercial Real Estate Capital Markets

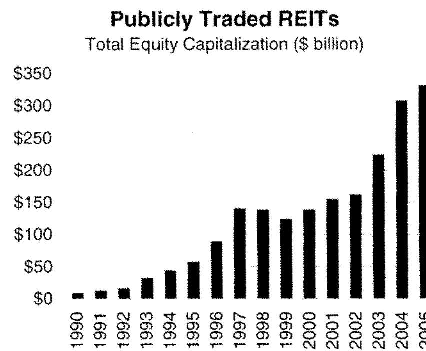
A Diversity of Equity Capital

A summary of the current buyers of commercial property highlights the diversity of investors and illustrates the secular changes that have occurred in the capital markets for commercial real estate since 1990. The growth of institutional and public equity capital in commercial real estate evidences its maturity as an accepted, primary asset class on par with stocks and bonds. Foreign capital is not new in commercial real estate, but the emergence of a global marketplace has been a significant recent development that continues to change the market. In addition, new investment vehicles have been formed to access capital from outside of Wall Street and institutional channels. A new breed of syndicators in the form of private REITs and tenancy-in-common interests, have

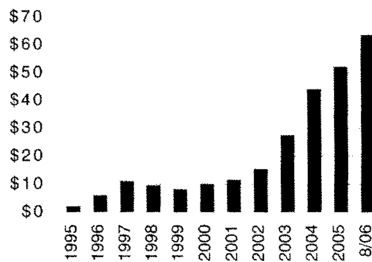
acquired almost $40 billion of commercial property since 2002. Private equity funds pool capital from a variety of sources and have acquired almost $80 billion since 2002. Originally called "Vulture Funds", these funds were born out of the Resolution Trust Company liquidations of bank real estate owned REO portfolios in the early 1990s. In addition, joint ventures between these large investors and local, private firms have proliferated. Consequently, the private sector has far greater access to capital and is less limited by geography. Few commercial real estate investors are local anymore as the mobility of capital nationally and globally has never been greater.

Public Real Estate Investment Trusts ("REITs")

The U.S. Congress created REITs in 1960 but the equity REITs in particular, only became a material part of the commercial real estate capital markets in the mid 1990s. Since then, REITs have flourished and have helped to transform the entire commercial real estate capital markets. Not only did REITs raise billions of capital dollars by allowing small investors to invest in large commercial properties, it helped bring in a new wave of transparency and scrutiny to the sector. Over the past decade, approximately 500 new analyst positions have been created solely to analyze the commercial real estate sector and the activity of the REITs. At the end of 2005, there were nearly 200 public REITs with a market equity capitalization of $330 billion and ownership over $750 billion of real estate properties. In 2005, public REITs accounted for approximately 14% of all commercial property acquisitions in the US.



source: NAREIT



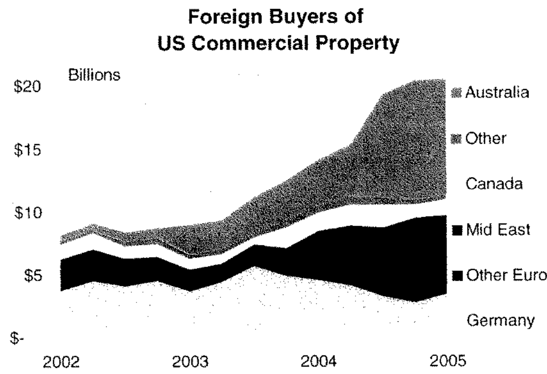
source: Merrill Lynch, AMG Data

Public REITs have gone through two major growth periods over the past decade. The first occurred in 1996-97 and the second occurred in 2003-04 as REITs became main-stream stock market investments. The role of REITs continues to grow as pension capital migrates from defined benefit plans to defined contribution (401K type) plans. As more 401(k) plans are providing the option, assets in real estate mutual funds, which invest primarily in REITS, have soared. Total assets of real estate mutual funds totaled $52 billion at the end of 2005, up from $10 billion just five years ago.

Foreign Investors

US commercial real estate has always held appeal among foreign investors. In the 1980s it was the Dutch and the Japanese. German investors accounted for the majority of foreign capital in the 1990s. However, until recently, most foreign investment was directed to trophy properties in a relatively select group of markets like Washington, New York and San Francisco. Thus, foreign buyers impacted prices in only a few markets and then for only the best real estate.

This is no longer the case as the globalization of the real estate industry has taken off and is clearly accelerating. In 2005, Australians purchased one of every ten community shopping centers that were sold in the U.S. as a diversity of buyers from around the globe are now active commercial real estate buyers. Moreover, the U.S. is now exporting real estate capital and U.S.-based private equity funds, among others, are significant investors throughout Europe, South America and increasingly, the Pacific Rim.

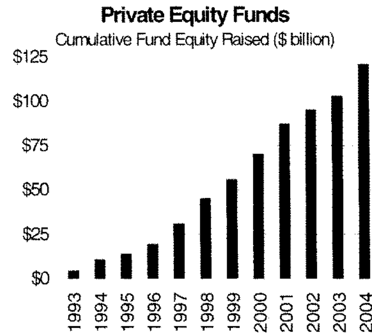


source: Real Capital Analytics

Globalization of REITs and CMBS is also taking off. In 2001 Japan entered the REIT arena and in 2003 France followed. The Netherlands, Singapore, Canada and Belgium and the UK recently changed their laws to create REITS. Hong Kong amended legislation last year to allow its REITs to invest in overseas real estate. North American companies still account for 50% of the world's REITs, but international REITs are growing quickly.

Private Equity Funds

Also known as hedge, equity or opportunity funds, Private Equity Funds pool capital in multi-million dollar increments from wealthy sophisticated "qualified" investors. They have currently amassed a huge amount of capital and are responsible for a wave of corporate takeovers throughout all industries, not just real estate. Real estate funds started in the 1990s and there are over 250 real estate specific hedge funds that have raised over $125 billion of equity. This equates to a buying power up to $500 billion since fund investments are often highly leveraged. However, not all of this capital will be invested in the US. Higher risk/higher return allocations by institutions and foreign investors are often placed with hedge funds, blurring the distinction between capital sectors. Fund sponsors are considered private since they invest their own equity and have discretion over the fund's investments.



source: Ernst & Young

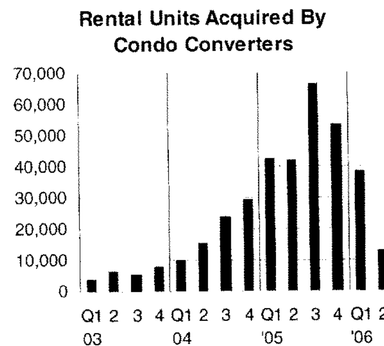
Syndicators

Private REITs and Tenancy-in-Common ("TIC") groups are part of the private sector that represent a relatively new group of buyers very different from the tax syndicators in the 1980s. These groups raise capital by syndicating equity through financial advisors to wealthy private individuals and families, primarily baby boomers nearing retirement. Most investors in the current syndications are seeking yield and a stabile cash flow. Consequently, TICs and private REITs acquisitions have generally been of higher quality, well occupied properties. TICs have an

additional benefit in that they qualify for 1031 like-kind exchanges that defer capital gains taxes to a later time. Combined, TICs and private REITs acquired $14 billion of core property in 2005, up ten fold since 2001. Private REITs accounted for $8.7 billion of acquisitions last year but their growth is slowing and total TIC acquisitions may exceed that of the private REITs. Despite all the press generated by this new class of investors, syndicators accounted for only 5% of all commercial property acquisitions in 2005.

Condo Converters

While the capital markets for residential and commercial real estate are unique, the home ownership and rental apartment housing markets are directly linked by the recent wave of condominium conversions. Converters were the most active buyers of apartment property in 2005 with over $31 billion of acquisitions. They differ from all the other classes of real estate investors in that they are cyclical buyers that can come and go quickly. Condo Converters arbitrage temporary pricing differences between the commercial income producing apartments and residential home ownership markets. Between 2004 and 2005, they acquired over 280,000 rental apartment properties in the commercial marketplace and sold them individually at higher prices in the residential home ownership market. Furthermore, this number excludes a significant number of properties converted by existing owners, new condo developments, and developments planned to be rentals but changed to condos prior to completion.



However, condominium conversion activity has fallen off sharply in 2006 as lenders started exercising greater discipline at the first sign of a slowing in the housing market. So far this year, just over $8 billion of condo conversion deals have been completed and the total for the year is likely to be half of the 2005 level.

The Ebb and Flow of Capital

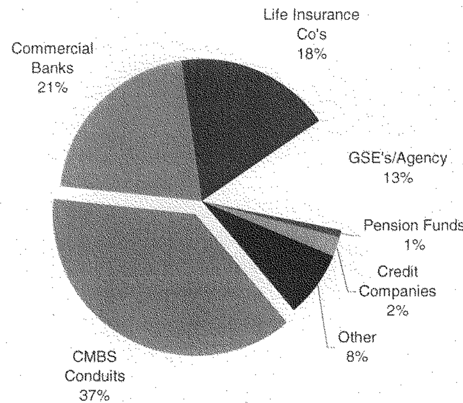
Condo converters serve as an excellent example of the natural ebbs and flows of real estate capital and the discipline of checks and balances that are now part of the capital markets. Condo converters appeared, dominated the market for a period, and are now quickly retreating as housing prices are no longer rising. Due to the diversity of capital sources now active for commercial real estate, other buyers have stepped in as condo conversion activity declined and there has been no significant price correction for commercial property. It also illustrates the information feedback loop that is now in place that should help to prevent large boom bust cycles in the future. Better real-time data on the housing market provided an early indication that condo sales were softening and condo converters and their lenders were able to curtail activity very quickly. Furthermore, banks that continued to lend aggressively on condo projects have been penalized in the stock market. Corus Bankshares, the leading lender to condo developers and converters, saw its share price fall 31% between June and August as investors became more circumspect of its loan concentration for condo projects.

A Diversity of Debt Capital

Total commercial and multifamily mortgage debt outstanding recently surpassed $2.7 trillion according to the Mortgage Bankers Association analysis of the Federal Reserve Board Flow of Funds data. The debt capital markets for commercial real estate have undergone the greatest transformation over the past decade. What was a private marketplace involving many regional

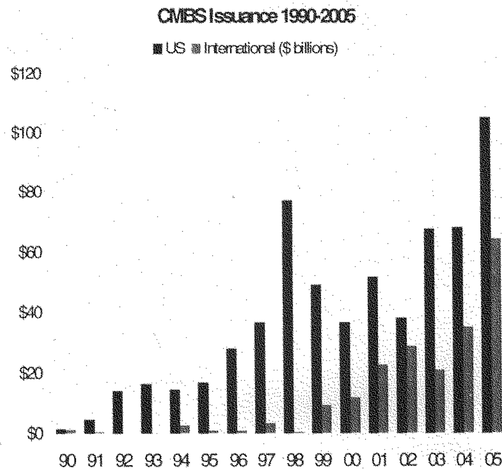
lenders has now become a national marketplace with a large public component. The securitization of commercial mortgages introduced public capital into the commercial real estate debt markets. Commercial Mortgage Backed Securities ("CMBS") were pioneered by the government's Resolution Trust Company in the early 1990s and are now the largest originators of commercial mortgages. In addition to the advent of CMBS, the introduction of interstate banking in 1994 allowed mortgage capital from the commercial banks to flow across state lines more easily. In a short period, the debt capital markets became more public and more efficient.

Commercial and Multifamily Mortgage Originations
2005 market share by volume



source: Mortgage Bankers Association

Domestically, CMBS originations reached $170 billion in 2005, up from less than $20 billion a decade earlier. CMBS conduits which source the loans accounted for 37% of all commercial and multifamily originations in the U.S. last year. Total outstanding volume of CMBS reached $683 billion at the end of 2005. Internationally, the CMBS market doubled in 2005 with nearly $70 billion in volume.



Source: Commercial Mortgage Alert

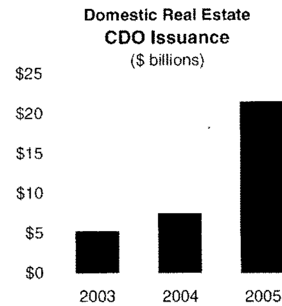
The CMBS market completed the fourth quadrant of capital for commercial real estate: private equity, private debt, public equity (REITs), public debt (CMBS). Four quadrants of capital define most mature financial markets but the CMBS market has helped to transform the industry in many other ways as well. It has brought an even greater level of transparency and much needed standards. CMBS has helped standardize underwriting, reporting and documentation throughout the entire industry. Standardization has facilitated the nationalization of the real estate debt capital markets and

has also lead to an active secondary market for commercial mortgages.

An option has developed for lenders to sell whole loans in an active secondary market for both performing and non-performing commercial mortgages. Commercial mortgages are now far more liquid assets than ever before. Thus banks that make loans in their local markets can sell those loans into the national capital markets and replace that investment with real estate securities that hold a nationally diversified mix of real estate debt. Thus local lending risk is substantially reduced.

The commercial real estate finance arena continues to evolve with new securitized products such as Collateralized Debt Obligations ("CDO"s) and new lenders, particularly for mezzanine debt or second mortgages. Origination volume of mezzanine loans tripled in 2005 to almost $13 billion according to the Mortgage Bankers Association which only started tracking mezzanine loans recently. Many of these mezzanine loans or whole loans purchased in the secondary market populate a new form of securitization called CDO's. Issuance of real estate CDO's tripled in 2005 to over $20 billion.

Domestic Real Estate
CDO Issuance
($ billions)



source: Commercial Real Estate Direct

Real Estate as an Asset Class

Perhaps the greatest change that has occurred in the commercial real estate capital markets since the 1980s is its perception within the greater investment universe. Many portfolio investors now consider commercial real estate as the fourth asset class along with stocks, bonds, and cash. The dot-com bust cemented this role when investors of all types and sizes realized they had previously been under allocated to this $24 trillion asset base (estimated by Prudential Real Estate Investors, January 2003).

In order for commercial real estate to become a true asset class, it had to become more transparent and win the trust of investors. Since the emergence of a public sector with the REITs and CMBS, the level of information and scrutiny throughout the industry has improved dramatically. The real estate discipline has gained stature relative to corporate America in recent years. Real estate ethics also trumped corporate America in a recent study by Roulac published in the Journal of Real Estate Literature. REITs were ranked as having the best corporate governance over all other publicly traded companies. Prior to the late 1980s, appraisal regulation was virtually nonexistent but since then the appraisal industry is characterized by well-trained and experienced professionals and solid appraisal policies and procedures. Real estate has also become a true profession and thus a popular academic discipline. The number of university real estate programs has doubled since the 1980s with over 600 dedicated faculty and 10,000 students currently involved in the study of the real estate industry.

Conclusion

The debt and equity capital markets for commercial real estate have evolved greatly since the late 1980s to become more diverse, sophisticated, efficient and transparent. The net result is a much greater level of liquidity and a lesser degree of risk for commercial property equity and debt investments. Regulation from within the industry and scrutiny of the public markets provides a layer of checks and balances that will help avoid boom and bust periods and ensure the liquidity of commercial property. Greater mobility of capital between the states and even internationally facilitates an even distribution of capital and decreases the likelihood of concentrations or a bubble occurring in individual markets. The real estate capital markets continue to evolve and grow to provide greater liquidity and mitigate risks throughout the commercial real estate industry.

Robert White, Jr.

He is the President of Real Capital Analytics, a national research and consulting firm that is headquartered in New York City. The company's research is focused exclusively on the investment market for commercial real estate. It collects transaction information for current commercial property sales and financings in every major U.S. market. It publishes a widely-read monthly newsletter entitled Capital Trends Monthly. Real Capital Analytics provides research on commercial real estate markets to over 400 clients, including lenders, brokers and appraisers. It is the primary provider of commercial real estate investment market data for major industry data providers like the National Association of Realtors, National Association of Real Estate Investment Trusts, as well as Property & Portfolio Research and Torto Wheaton Research. In addition, research and data compiled by Real Capital Analytics on the commercial real estate market has been cited numerous times by the various federal banking agencies.

Prior to starting Real Capital Analytics, Mr. White spent 14 years in the real estate investment banking and brokerage industry. He was formerly a managing director and principal of Granite Partners LLC and spent nine years with Eastdil Realty in New York and London. Mr. White is a noted authority on the commercial real estate capital markets with credits in the Wall Street Journal, Barron's, The Economist, Forbes, New York Times and Financial Times, among others. In addition, he was named one of National Real Estate Investor Magazine's "Ten to Watch" in 2005.

Mr. White is a graduate of the McIntire School of Commerce at the University of Virginia. He is also a Counselor of Real Estate and is a fellow of the Homer Hoyt Institute.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

SHEILA C. BAIR
CHAIRMAN

November 27, 2006

Honorable Spencer Bachus
Chairman
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for your followup questions subsequent to my testimony before the Subcommittee on September 14 regarding an update on the new Basel Capital Accord.

Enclosed are my responses to your questions. If we can provide further information, please do not hesitate to contact me at 898-6974 or Eric Spitler, Director, Office of Legislative Affairs, at 898-3837.

Sincerely,

Sheila

Sheila C. Bair

Enclosure

Response to Questions by
The Honorable Spencer Bachus

Q.1. In your testimony, you note the important role that capital plays in maintaining the safety and soundness of our banking system. Some analysts suggest, however, that regulatory capital levels that are too high can be harmful to the banking industry and the economy. That is, excessively high amounts of capital can reduce the availability of credit in the United States and even encourage banks to engage in riskier activities in order to generate the earnings to support the high capital requirements. How do you determine what is the right balance for regulatory capital requirements?

A.1. Experience has taught the FDIC the critical importance of maintaining sufficient capital. Capital serves as a buffer against unanticipated loan losses and, in aggregate, protects the integrity of our financial system. The challenge for any risk-based capital system is finding the right balance between safety and soundness objectives and the encouragement of bank lending and growth.

Banks fund their loans with shareholder equity capital, as well as deposits and other types of debt financing. In deciding on the right mix of debt and equity funding, the bank must plan for the possibility that its loans might perform worse than expected, while it continues to be liable to make full contractual payments to depositors and other creditors. With sufficient capital invested by the shareholders, the bank can weather periods of adversity. But without sufficient capital the bank may be unable to extend new credit or even become insolvent.

Business firms of all types must decide the right mix of debt funding relative to shareholder equity. Banks operate with much higher proportions of debt relative to equity than other commercial firms. They can do this in part because the financial assets they hold are generally more liquid than the non-financial assets of commercial firms. Importantly, however, banks also benefit from explicit and implicit safety net protections such as deposit insurance, a lender of last resort and, for some institutions, a "too big to fail" perception. These protections make it possible for banks to attract deposits and other forms of credit on attractive terms from creditors who do not perceive much risk in lending to a bank.

Without appropriate capital regulation, an incentive can exist for banks to operate with relatively low capital ratios. The lower a bank's capital relative to its overall volume of business as measured by assets, the greater the likelihood that unforeseen economic events, significant errors in model assumptions or accounting methodologies, or other undetected problems might create serious problems for the bank. U.S. banking history provides numerous examples of such problems. The costly taxpayer bailout of the savings and loan industry has been attributed in part to a systemic failure of supervisors to provide adequate capital regulation.

The Basel Committee on Banking Supervision understood that a systematic and substantial reduction in worldwide bank capital standards could pose considerable risks to the safety and soundness of banks and the financial system. In the Basel text, "International Convergence of Capital Measures and Capital Standards," the Committee stated the following:

> "The Committee believes it is important to reiterate its objectives regarding the overall level of minimum capital requirements. These are to broadly maintain the aggregate level of such requirements, while also providing incentives to adopt the more advanced risk-sensitive approaches of the revised framework." (paragraph 14)

The level of capital at U.S. banks can be evaluated from at least three perspectives: their ability to prosper and compete, their ability to provide credit to fund economic growth, and the government's interest in avoiding costly draws on the federal banking safety net. We do not believe U.S. banks hold excessive amounts of capital based on any of these perspectives.

Available evidence suggests that capital levels have not hindered banks' ability to prosper and compete or their ability to extend credit to fund economic growth. During the 10-year period 1995-2005, FDIC-insured banks' growth in loans, assets, and net income significantly outpaced the growth of the broader economy (see table below). Insured banks have had record profits in 13 of the past 14 years, topped by the most recent net income of $134 billion in 2005.

Bank Growth and Profitability Outpace the Broader Economy
Average annual percent growth in nominal dollars, 1995-2005

FDIC-insured institutions			U.S. economy
Assets	Loans	Net Income	GDP
7.5%	7.5%	9.1%	5.3%

Source: Calculations are based on information from FDIC "Statistics on Banking" (http://www2.fdic.gov/SDI/SOB/) and data compiled by the Bureau of Economic Analysis.

The FDIC also does not believe banks hold excessive capital from a safety-net protection standpoint. While current industry capital is adequate, we do not believe substantial reductions in that capital would be prudent from a safety and soundness perspective.

In summary, capital serves an important shock absorber function by ensuring that unforeseen economic events, significant errors in model assumptions or accounting methodologies, or other undetected problems do not cause serious problems for banks. Banking problems, especially at our largest and most systemically important banks, can impose costs on the broader economy and financial system, on the deposit insurance funds, and on the fiscal position of the U.S. government. Appropriate levels of bank capital need to reflect the government's interest in avoiding such costs.

Q.2. In your testimony, you note that the FDIC and the other banking agencies have agreed to ask a question about the standardized approach as an option for core banks. If the banking agencies decide to offer the standardized approach as an option, are you comfortable with the standardized approach that was agreed to internationally in 2004?

A.2. The international Basel II text includes a Standardized Approach that is available to any bank that wishes to adopt it. This Standardized Approach has several advantages over both the existing rules and the Advanced Approaches offered in the Basel II NPR. We believe a version of the Standardized Approach, as developed through the U.S. rulemaking process, merits consideration as a viable capital framework for any U.S. bank.

The Standardized Approach is considerably more risk sensitive than the existing rules, provides banks with incentives to mitigate and manage risks, and closes some loopholes in the existing rules that allowed banks to reduce their capital requirements without reducing risk. Further, the Standardized Approach allows for these advances in a more gradual and moderate manner than the Advanced Approaches.

In reaching a decision on whether to allow banks to use the Standardized Approach, the FDIC will consider the attributes that need to be present in any regulatory capital system.

- A regulatory capital system must require banks to hold adequate capital to avoid costly draws on the federal banking safety net. The Standardized Approach avoids the potential for substantial reductions in bank capital requirements inherent in the Advanced Approaches.

- A regulatory capital system should avoid undue burden on the banking industry. The Standardized Approach is simpler and less costly to implement than the Advanced Approaches.

- A regulatory capital system should not tilt the playing field in favor of one group of banks over another. The Standardized Approach does not appear to pose the same potential for competitive inequities across banks of different sizes as does the Advanced Approaches.

- A regulatory capital system should not interfere with innovation or the evolution of risk management. Some believe it is necessary to base regulatory capital on internal models in order to encourage sound risk management, and the FDIC will be attentive to comments on this point.

There also are a number of more technical issues that would need to be addressed if the federal regulatory agencies chose to allow large internationally active banks to use a version of the Standardized Approach. A notable example is the issue of capital requirements for operational risk. The agencies are seeking comment on how to address

this and other technical issues with the Standardized Approach as we decide whether it would provide an appropriate framework for capital regulation in the United States.

Q.3. In your testimony, you express support for a risk sensitive capital system. You also cite a need for the continuation of the leverage ratio to ensure a baseline of capital. On the other hand, witnesses from the banking industry suggested that a leverage ratio is inconsistent with a risk sensitive capital system. Under what circumstances, if any, would it be appropriate to review the role of the leverage ratio in the U.S.?

A.3. For 15 years, the U.S. has had in place a dual framework of capital regulation, consisting of risk-based rules and a leverage requirement that capital exceed specified ratios of balance sheet assets. This dual framework of capital regulation has supported the safety, soundness, and resilience of the U.S. banking system. Our banks enjoy not only strong capital but high profitability. There is no indication that our capital framework has constrained banks' ability to extend credit.

The leverage framework and the risk-based framework work well in tandem. The risk-based rules capture off-balance sheet risks and other risks not captured by the leverage ratio. The leverage ratio ensures a stable base of capital to ensure unforeseen developments do not cause substantial banking problems. History provides numerous examples where severe economic downturns, model errors, accounting adjustments, and issues undetected by the supervisory process caused severe problems or failures of banks and other financial institutions. The Advanced Approaches have the potential to reduce capital requirements to levels insufficient to address these risks. The Advanced Approaches therefore elevate, rather than diminish, the importance of the leverage ratio.

Q.4. During the hearing, you suggested that it may be appropriate to extend the leverage ratio internationally. What is the status of your discussions with foreign regulators on this concept? What type of response have you received from foreign regulators?

International supervisors had an open and frank exchange of views on the leverage ratio at the recent Basel Committee meeting in Merida, Mexico, in early October. Other countries have alternative approaches to ensuring adequate levels of capital. For this reason, the FDIC has agreed to undertake a study of the various approaches used by supervisors to ensure a stable base of capital regardless of the levels indicated by the Basel minimums. While we are early in the process, the timing is right for such a discussion as many countries are very close to adopting the new Basel II capital framework and as the agencies approach a decision on how to proceed with Basel II in the U.S.

It is extremely important that capital requirements not become a tool for international competition. Our U.S. statutory and regulatory framework are rooted in promoting a strong private sector banking system that does not become a source of economic or fiscal weakness through over reliance on implicit or explicit federal subsidies. Strong capital

has been a strength to the U.S. banking system and indirectly to our economy. The U.S. approach to the international dialogue should be to encourage strong standards world-wide rather than to lower the bar domestically.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

SUSAN SCHMIDT BIES
MEMBER OF THE BOARD

December 14, 2006

The Honorable Spencer Bachus
Chairman
Subcommittee on Financial Institutions
and Consumer Credit
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am pleased to enclose my responses to your additional questions in connection with the hearing on "A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate." I have also forwarded a copy of my response to the full Committee for inclusion in the hearing record.

Sincerely,

Susan Schmidt Bies

Enclosure

Governor Susan Schmidt Bies subsequently submitted the following in response to questions received from Chairman Bachus in connection with the September 14, 2006, hearing before the House Subcommittee on Financial Institutions and Consumer Credit:

1. **One of the concerns voiced by some in response to the standardized option for core banks is that such an option would hamper the development of risk management practices at core banks. However, I understand that the Board has issued a supervisory letter, SR 99-18, which is aimed at risk management practices. Does not this supervisory letter give the Board adequate comfort that appropriate risk management practices are in place, even if core banks are able to adopt the standardized approach for calculating minimum capital requirements?**

Answer: The Federal Reserve's issuance of SR letter 99-18 was intended to provide Federal Reserve supervisors with additional information about internal capital measures at large banking organizations, and also promote improvements in the overall assessment of capital needs at large banking organizations. In the seven years since SR 99-18 was issued, the Federal Reserve believes that there has been vastly increased understanding by our examination staff of internal capital processes at large banking organizations; this understanding clearly aids in the evaluation of safety and soundness at these institutions. In addition, we believe that SR 99-18 has helped enhance the internal capital processes that large banking organizations employ.

That said, one must remember that SR 99-18 is only a Federal Reserve document and is not applied on an interagency basis. Other U.S. banking agencies have chosen not to issue specific guidance along the lines of SR 99-18. Furthermore, supervisors in many other countries also have not provided specific guidance on banks' internal capital assessment processes. One of the major anticipated benefits of Basel II is its requirement for banks to develop and maintain an Internal Capital Adequacy Assessment Process (ICAAP) under Pillar 2. Each institution must assess its own capital needs in Pillar 2 based on its individual risk profile, and this is in addition to the quantitative requirements to determine minimum risk weighted capital under the Pillar 1 regulatory requirements. As part of Pillar 2, the primary supervisor will also verify that each banking organization has satisfied the requirements of Pillar 1. We believe that the ICAAP requirement is very much in line with the work that the Federal Reserve has been conducting under SR 99-18, and so we welcome a chance to have U.S. and foreign supervisors agree on a common language to evaluate banks' internal assessments of capital adequacy.

Finally, we believe the advanced Pillar 1 regulatory capital approaches of Basel II are most appropriate for the largest, most complex banking organizations, given the complex risk profiles of these organizations. Improving risk sensitivity of regulatory capital requirements is a key objective of the Basel II framework, and the standardized approaches for credit and operational risk may not adequately capture the risks of the largest, most complex organizations. Moreover, key advantages of the advanced Pillar 1 approaches of Basel II are that they (i) encourage improvements in risk measurement and management at the participating banking institutions, (ii) facilitate the integration of regulatory capital requirements with internal risk measurement and management processes; and (iii) provide a common risk measurement and management vocabulary for banks and supervisors to use. Such synergies between the standardized Basel II

approaches to regulatory capital and risk management would be quite limited. The U.S. Agencies will carefully review comments on the appropriateness and specific form of the standardized approach for credit risk for U.S. banking institutions.

2. **In your testimony, you emphasize the risk sensitivity of the advanced approach. While the standardized approach may not be as risk sensitive as the advanced approach, is it not more risk sensitive than the current Basel I regime? I understand, for example, that the commercial loan credit risk weights under the standardized approach are based, primarily, upon external ratings from credit rating agencies. Are not such ratings appropriately risk sensitive?**

Answer: The standardized approach in the New Basel Accord is more risk sensitive than the current Basel I regime. However, it does not appear to be risk sensitive enough to accommodate the very wide spectrum of risks that large, complex, internationally active banks take, both on and off their balance sheets. The Basel II standardized approach was designed by the Basel Committee to replace Basel I for smaller, less complex banks because in many countries Basel I would not be available once Basel II is implemented.

You are correct that in the Basel II standardized approach, commercial debt risk weights are based on external credit ratings where such external credit ratings exist. However, most corporate debt issuances do not have external credit ratings, and under the standardized approach unrated commercial loans and bonds (which comprise the bulk of the C&I loan portfolio of U.S. banks) will continue to be risk weighted at 100 percent, as they are currently under Basel I. In other words, under Basel II standardized, most wholesale credit exposures of a bank would be risk weighted at a flat 100 percent, regardless of the creditworthiness of the corporate borrower and regardless of the presence of many forms of collateral. In addition, the Basel II standardized approach also has limited risk sensitivity in the area of retail exposures. For example, first-lien mortgage loans would generally be assigned a 35 percent risk weight and other retail loans would generally get a 75 percent risk weight, in each case regardless of the creditworthiness of the borrower. The advanced approaches in Basel II provide a substantially more risk sensitive capital requirement that takes into account the creditworthiness of the bank's borrowers and counterparties and the presence of a complete range of credit risk mitigants, such as collateral and guarantees.

3. **During the hearing, you indicated that any competitive disparities created by the Basel II NPR would be transitional in nature because you expect foreign regulators to change their standards to adopt some of the elements included in the U.S. NPR.**

    a. **How far along are these discussions with foreign regulators, and what timetable, if any, is there for foreign countries to modify their version of Basel II?**

    b. **Could you specify, specifically, which features of the NPR you believe foreign regulators will be adopting? For example, is the 10% aggregate floor under discussion or the definition of default?**

c. If foreign regulators do adopt these additional features, how would you suggest we address the competitive imbalances that could well result from the differences in the U.S. rule and the version adopted in other countries?

Answer: The Federal Reserve continues to have ongoing dialogue with our counterparts in other countries, through the Accord Implementation Group and other forums, regarding the implementation of Basel II. These discussions have been very productive to date in identifying a wide range of home-host issues that can then be addressed more fully on a case-by-case basis with the individual banks involved and their relevant bank supervisors. Although these discussions have been productive, we cannot predict at this time which, if any, features of the Basel II NPR foreign regulators will be considering.

We anticipate that the Basel Committee will address interpretive issues that arise under Basel II as it did after the adoption of Basel I. Moreover, the Committee has determined that it will review implementation issues and the scaling factor, sometimes referred to as the 1.06 multiplier, at the end of the transitional period.

The Federal Reserve will be looking at implementation issues during the comment period on the Basel II NPR and welcomes industry input on potential competitive disparities arising from the U.S. proposal. Before we issue a final Basel II rule, we intend to review all material differences between the Basel II NPR and the version of Basel II implemented in other countries. For example, we will consider the need for any changes to the proposed U.S. definition of default. The agencies revised this definition based on comments received on the Basel II Advance Notice of Proposed Rulemaking and further revisions may be appropriate to harmonize the U.S. version of Basel II with the versions in other countries.

At the end of the day, there will be differences between the U.S. version of Basel II and the versions adopted by other countries. National differences in capital regulation are not unique to the Basel II capital regime. Over the years, the U.S. agencies have consciously chosen to maintain a generally somewhat more conservative U.S. version of Basel I than those versions of Basel I adopted by other countries. In addition, the U.S. banking agencies currently impose a supplemental leverage ratio, and risk based capital is linked to our prompt corrective action framework.

Our existing capital rules, while somewhat more conservative than those of other countries, certainly have not been a barrier to financial success of our banks. Taken as a group, the largest U.S. internationally active banks continue to be more profitable than many banks in other countries. Capital strength and the resilience it demonstrates offers some competitive advantages, which is a key reason that most of the world's largest banks hold capital in excess of minimum standards. Creditors and counterparties will always consider capitalization when assessing the risks associated with these banks.

We recognize, nonetheless, that minimum regulatory capital requirements can have marginal effects on competitiveness and profitability, particularly with regard to individual products or funding structures. The modifications made to the current Basel capital framework in the United States since its initial implementation demonstrate the banking agencies' continuing interest in

addressing potential imbalances and new banking products. But many other factors other than minimum regulatory capital--including domestic and international tax policies, economies of scale and scope, risk management skills, and the ability to innovate--also affect competition and profitability. On balance, the Federal Reserve believes that an appropriately conservative approach to capital adequacy serves the interest of the United States in maintaining the safety, soundness, and resiliency of our banking system.

4. **Almost all other major developed countries have given their banking institutions the ability to select the advanced approach or the standardized approach for Basel II compliance. Your agency, which has led U.S. negotiations on the Accord, approved the standardized approach in 2004. When you did so, did you think it would provide a suitable method for determining minimum capital requirements? If not, why did you agree to include it as an option in the international Accord in 2004?**

Answer: In the United States, Basel II is expected to apply to only 10 to 20 large, complex banking organizations, which is why the U.S. agencies are only proposing the advanced approaches (A-IRB for credit risk and AMA for operational risk). Perhaps the main difference between the implementation of Basel II in the United States and most other countries is that the U.S. banking agencies plan to retain a revised form of the existing Basel I capital rules for the vast majority of U.S. banks; most other countries are replacing Basel I entirely and will apply Basel II to the entire banking system. Therefore, those countries need to use the simpler versions of Basel II--that is, the standardized approach for credit risk and the basic indicator or standardized approach for operational risk--for their smaller, non-complex banks. For this reason, the Federal Reserve supported the inclusion of simpler approaches in the New Basel Accord. Notably, the U.S. ANPR for Basel II, issued in August 2003, proposed that only the advanced approaches be used in the United States; comments received on the ANPR did not indicate any opposition to the agencies' choice of proposed approaches nor did they request allowing the standardized approach as an option in the United States.

In developing U.S. proposals for Basel II implementation, the agencies did not think it would be appropriate to replace the existing Basel I capital rules for small, non-complex banks in this country with the Basel II standardized rules. The agencies concluded, based in significant part on input from small, community banking organizations, that the implementation costs of such an overhaul generally would exceed its regulatory benefit. Instead, the agencies have just proposed a simpler, more modest set of revisions to our existing Basel I-based capital rules for smaller U.S. banks. But as part of the Basel II and Basel IA NPRs, the agencies are seeking comment on whether we should adopt some form of the Basel II standardized approaches in the United States.

5. **I understand that foreign banks, but not U.S. banks, have participated in a QIS V study to further assess the impact of the Basel II capital regime on capital levels. What were the results of the QIS V study? Also, of the almost 300 foreign banks that participated in the most recent QIS V study, how many adopted the advanced approach, and how many adopted the foundation and standardized approach?**

Answer: Although the United States did not directly participate in QIS V, where possible the QIS V results in many cases included the results of the QIS IV study conducted in the United States, despite differing data collection time periods. The results of the two studies were strikingly similar. In particular, the QIS V results for the G10 countries suggested (i) minimum regulatory capital requirements under Basel II would decrease relative to the current Accord, (ii) there was significant dispersion across institutions, attributable to a combination of differences in both portfolio characteristics and estimation methodologies, and (iii) that benign macroeconomic conditions at the time QIS IV and V were conducted influenced the results.

The G10 banks were divided into two groups: Group 1 consisted of banks that have tier 1 capital in excess of €3bn, are diversified, and are internationally active; Group 2 consisted of all other banks. The table below indicates how many of the 202 non-U.S. G10 banks were planning, at the time the data were collected, to adopt each of the advanced (AIRB), foundation (FIRB), and standardized approaches for credit risk, separated by group. Among the non-G10 countries, the vast majority of institutions reported they were most likely to adopt the standardized approach (not shown in table). In contrast, of the 56 largest, internationally active non-U.S. institutions, not one indicated it was most likely to adopt the standardized approach for credit risk.

Number of observations in each cell classified as "most likely"	Standardized Approach	FIRB approach	AIRB approach
G10 Group 1	0	23	33
G10 Group 2	33	102	11

Source Federal Reserve calculations based on "Results of the Fifth Quantitative Impact Study," Table 3, BCBS

6. **The Basel Committee concluded that the QIS IV and V results do not require an adjustment to the framework, and, therefore, they determined not to modify the framework. Why did the U.S. regulators reach a different conclusion?**

Answer: With respect to the QIS IV and V results and their interpretation and implications, the U.S. regulators reached a similar conclusion to their foreign counterparts. In its 24 May 2006 Press Release, the Basel Committee announced that it had decided to maintain the current calibration (1.06 scaling factor for credit risk-weighted assets), based on QIS IV and V results. This announcement mirrored the decision made earlier by the U.S. regulators to retain the 1.06 multiplier in the Basel II NPR. In addition, in both the Basel II NPR and the Basel Committee announcement, it was highlighted that due to the uncertainties and limitations of the data available at the time, no change was warranted, leaving open the door for subsequent adjustment at a later date if appropriate. We continue to view the 1.06 scaling factor as reasonable at this time, subject to further modification at a later date. The fact that the scaling factor was not adjusted in the aftermath of the QIS IV and V exercises does not indicate that it has been permanently established.

The agencies did propose a number of transitional safeguards in the Basel II NPR that are not present in the EU's capital requirements directive (CRD) implementing Basel II. Part of the explanation for the closer alignment of the CRD to the framework rests in the timing differences between the U.S. and European Basel II implementation processes. In the United States, QIS IV

was conducted prior to the release of the Basel II NPR, while Europe did not conduct QIS V until after the passage of the CRD. Hence, in the United States, we had the ability to assess the results of QIS IV before issuing our proposed Basel II rule; our European colleagues did not have the same flexibility.

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

November 30, 2006

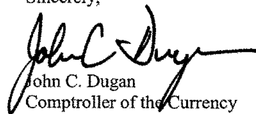
The Honorable Spencer Bachus
Chairman
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

Thank you for the opportunity to present the views of the OCC at the hearing entitled "A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate" held on September 14, 2006. Enclosed are responses to the additional questions you sent us to complete the hearing record.

I hope these responses are helpful. Please do not hesitate to contact me if you have further questions.

Sincerely,



John C. Dugan
Comptroller of the Currency

Enclosure

Questions from Representative Bachus

1. In your testimony, you expressed support for a risk-sensitive capital system for complex banking institutions. Presumably, capital levels will fluctuate under such a system. That is, they will decrease during good economic periods and increase during poor economic periods. How much fluctuation is appropriate?

At the bank level, we expect that fluctuations will be reflective of risk. In our view this is not likely to be a material problem. Economic conditions vary over time, and certainly will continue to do so. As a result, the level of risk faced by banks varies over time, and will continue to do so. If the capital that serves as a cushion against this risk does not similarly change over time, then bank soundness must necessarily vary. In the same way, under a risk-sensitive capital standard, required capital should vary over time as risk varies, just as required capital should vary across banks if banks have different risk profiles. If required capital does not vary, its utility as a measure of bank soundness will be diminished.

In addition, it is likely that the negative effects of pro-cyclicality that raise the greatest concerns are those stemming from unanticipated changes in required risk-based capital. A benefit of the Advanced IRB approach is that it relies on forward-looking estimates of risk. If these systems operate as intended – and again, with the significant improvements in bank credit information systems currently in progress or contemplated as part of implementation – it should be easier to anticipate problems farther in advance, reducing the frequency and severity of surprises. More capital will be required when the probability of loss increases, rather than when losses are actually incurred. The reduction of unanticipated shocks to bank capital, and the avoidance of heavy reactionary steps to rebuild capital during periods of loss, could make bank credit less pro-cyclical under Basel II than it is today.

Banks are aware that risk varies over time; this variation is one of many elements that introduce uncertainty into their own internal assessments of capital adequacy. Banks take steps to address this uncertainty – through capital buffers, conservatism, rating philosophy, and so on – and will continue to do so. Their ability to do so may even be enhanced by the improvements contemplated under IRB, with its conceptually sound view of risk and its requirements for improvements in data and information systems. Although the incentives banks have to address cyclicality are unlikely to be identical to those of regulators, the incentives are in the same direction.

Enhancing the risk-sensitivity of required capital is one of the most important features of the new framework. It is important to recognize that if risk goes up – for example in an economic downturn – and capital does not, the soundness of the banking system may be jeopardized. Historical and international experience shows that a weak banking system can be a drag on the economy. We are better served by a system in which capital is appropriately sensitive to risk, and where banks and bank supervisors are prepared to use other tools to address any cyclicality problems that might arise. Additionally, making required capital less "cyclical" by making it less risk sensitive will not make variation in risk go away; it will simply make capital a less useful signal or metric of that variation. To reap the information and other benefits of a risk-

sensitive capital standard, it is probably necessary to accept a degree of variation in capital requirements over time, because risk varies over time.

2. If a risk-sensitive capital system offers benefits over a system that is not risk sensitive, should not the risk-based rules be the operative standard in setting minimum capital requirements? If non-risk-sensitive rules control, do we not create a selection under which risk-based rules are for information purposes only?

The leverage ratio is a crucial element of our current regulatory capital and PCA frameworks, and has coexisted with the risk-based regime for many years. We do not view the current risk-based capital requirement as "informational," nor would we view the revised risk-based capital requirements of Basel II or Basel IA that way. One of the primary purposes of these revisions to the risk-based standards is to align the regulatory capital requirements more closely to the actual risk of the bank's activities. We believe that the simple leverage requirement complements the more refined risk-based system, and that the leverage requirement can run in parallel to the IRB regime without undermining the efficacy of that more risk-sensitive measure.

3. Many analysts believe that capital is a lagging indicator of safety and soundness. In other words, declines in capital do not predict problems, but result from existing problems on the bank's balance sheet. If this is correct, is it possible that the Basel II approach places too much emphasis on capital levels, and not enough on Pillar 2 supervision?

We believe that both Pillar 1 and Pillar 2 are important, and that both are incorporated into the current U.S. regulatory structure and procedures. As such, the Basel Committee's new framework is consistent with current U.S. supervisory practices. Capital rules and the level of a bank's minimum required capital generated by those rules is only one of the tools we use to ensure that a bank remains sound. On-site supervision plays an important complementary role in ensuring capital adequacy.

Supervisory reviews confirm compliance with minimum regulatory capital requirements, while identifying the limitations of those requirements – including risks not covered or not adequately quantified -- and encourage banks to develop better risk management techniques for monitoring and managing their risks. Supervisory review is also intended to ensure that each institution is able to assess its own individual capital needs (beyond regulatory capital requirements), based on its risk profile and business mix. Finally, supervisory review is premised on the ability and willingness of supervisors to intervene at an early stage to prevent an individual bank's capital from falling below the appropriate level required to support its risk profile.

Notwithstanding the forward-looking perspective of on-site supervision, we recognize that losses can reduce capital, and therefore, that a given decline in capital may be a result of past problems rather than an indicator of future problems. However, most studies of bank failure, downgrades, or other measures of banking distress conclude that capital is one of the most important predictors of future problems: banks with lower capital ratios are more likely to experience problems, all else equal. This consistent finding is not surprising, because the major function of capital is to protect against potential future losses, particularly those that are unanticipated.

4. In your testimony, you state that there may well be parts of the Basel II NPR that are "overly conservative." What parts of the NPR fall into that category?

Affected institutions already have expressed their view that the U.S. transitional floors are far more conservative than the floors contained in the June Framework. Similarly, they have criticized the 1.06 multiplier. Other issues have been presented in an industry document, "Competitive Disparities Created by the U.S. Version of the Basel II Capital Accord." The Agencies will carefully consider all the comments we receive with an eye to eliminating those U.S.-only features that are not needed for safety and soundness purposes.

5. In your testimony, you note that one of the fundamental goals of the Basel II NPR is to ensure that bank risk management practices are commensurate with the risks facing the banking industry. I would assume that the risk management systems in place in our largest multi-national banking institutions are among the best and most advanced in the world. Has the OCC recommended any changes to the existing risk management systems currently being used in banks today?

Yes, as part of our supervisory responsibilities, we make recommendations regarding how a bank should improve its risk management and measurement systems. This is a regular and continual component of our supervisory process. However, we generally do not dictate the specifics of those systems, because we recognize the diversity of practices and the on-going evolution in risk management. Our expectation is that a bank's measurement and management systems will keep pace with that evolution, and that their systems will be appropriate for the complexity and level of risk inherent in the bank's activities.

It is important to note that the scope of risk management systems under Basel II is limited to those risk management systems that are needed for the estimation of regulatory capital requirements. The OCC recommends changes to bank risk management systems on an ongoing basis in order to ensure national banks continue to operate in a safe and sound manner, and comply with applicable laws and regulations. Examples include: BSA/AML compliance, information security, credit card account management, home-equity lending, non-traditional mortgage products, and commercial real estate.

6. How would the Basel II NPR impact existing risk management systems in our largest banks? What additional authority does Basel II give the OCC beyond what is already in place to require banks to properly manage risk?

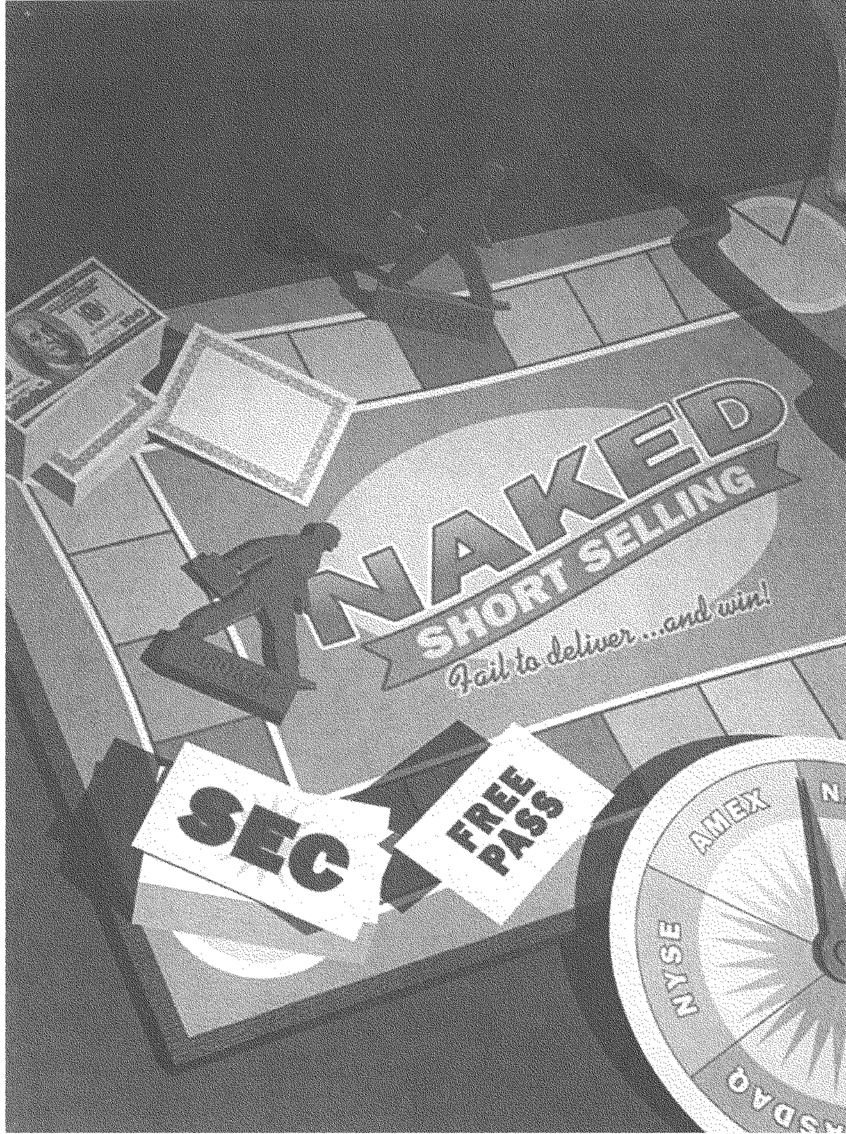
The Basel II NPR promotes enhanced risk measurement and management systems for credit risk and operational risk. For a bank to qualify to use the advanced approaches, it must have the following risk management systems and processes:

- *A rigorous and comprehensive process for assessing its overall capital adequacy in relation to its total risk profile.*
- *Consistency in the systems and processes used for risk-based capital purposes with those used for internal risk management processes.*

- *Internal rating/segmentation systems that rank order credit exposures along two dimensions (risk of default and risk of loss given default). Internal rating/segmentation systems must also be sufficiently granular, transparent and well documented.*
- *An independent process that validates the accuracy and reliability of internal rating systems on an ongoing basis.*
- *Enhanced data collection to identify key drivers of credit risk and operational risk.*
- *Systems that capture, store and retrieve risk data electronically, and provide for regulatory capital reporting on a quarterly basis.*
- *A rigorous and comprehensive quantification process that translates risk data and characteristics into parameter estimates or inputs for risk-based capital models.*
- *A rigorous and comprehensive validation process for internal models used to determine regulatory capital requirements.*
- *Strong oversight and control mechanisms that provide assurance to the Board of Directors that the bank is compliant with U.S. qualifying criteria, and risk management systems for A-IRB and AMA are functioning effectively and producing accurate and reliable results.*

While most mandatory Basel II banks have some elements of these risk management systems in place or in development, there are wide variances among banks in the details and in the extent of application. The advanced approaches are not designed to, and will not, eliminate all the variances in the underlying details of bank risk management systems. However, early Basel II preparations have already intensified bank efforts to re-evaluate and strengthen risk management systems.

The Agencies have the ability, through existing tools, to address those instances where banks are not properly managing risks; however, as a final rule the Basel II NPR would provide additional legal authority to ensure proper risk management. In addition, the current regulatory capital regime contains provisions should a bank fail to meet the requirements of the regulations. In this regard, Basel II would not be a fundamental change as safeguards such as the leverage ratio and Prompt Corrective Action will be retained. Thus, to the extent a bank fails to meet the requirements specified in the final Basel II regulation, the Agencies would have the authority to take appropriate action to ensure that remedial actions are taken, regardless of whether they involve risk management systems or unwarranted declines in regulatory capital.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NYSE

Games Short Sellers Play

Traders who sell shares they don't own—and haven't even borrowed—are driving down prices. More than 425 companies a month may be the victims of these schemes.

By Bob Drummond

Movie Gallery Inc. shares fell 20 percent on Feb. 3, their biggest nosedive in almost a decade. At the time, there didn't seem to be a reason for the jaw-dropping rout. Analysts who follow Dothan, Alabama-based Movie Gallery, the second-largest video rental chain in the U.S., speculated that investors were spooked after a large money manager cut its stake or that they were worried sales figures wouldn't meet expectations.

Another possible factor surfaced two weeks later, and it had nothing to do with financial performance. On Feb. 17, the Nasdaq Stock Market added Movie Gallery to a list of stocks considered, under a new U.S. Securities and Exchange Commission regulation, to be at risk for manipulation by naked short sellers. In naked shorting, traders who hope to profit from falling prices sell shares without borrowing stock. Using that strategy, naked short sellers can drive down prices by flooding the market with orders to sell shares they don't have.

"These people are lying, they're cheating and they're stealing," says Wes Christian, a Houston lawyer who represents Internet discount retailer Overstock.com Inc. and more than a dozen other companies that say their stocks were pummeled by naked shorting. "This is, in our opinion, the biggest commercial fraud in U.S. history."

Movie Gallery Chief Financial Officer Thomas Johnson says he has asked the SEC to investigate whether naked short sellers helped undercut the stock. "I'm throwing out the towel, saying 'Help me,'" Johnson, 43, says. "There are rules designed to deal with this, and people are still managing to do these naked short sales. It's extremely frustrating. It's like being on the front line and people are shooting you from every direction."

In traditional short selling, traders rely on a strategy that's the mirror opposite of the time-honored adage to buy low and sell high. Short sellers borrow stock through a broker

ILLUSTRATION BY ELIOT BERGMAN

and hope to profit by selling shares high and later buying them back at lower prices to repay the loan. Naked short sellers do the same thing, with one difference: They don't borrow any shares. Naked short selling isn't illegal in most cases, unless authorities can prove fraud, such as a scheme to manipulate stock prices.

The threat to investors arises because traders in naked short sales aren't limited by the number of shares available to borrow. If a naked short seller doesn't intend to borrow stock, he can pump a theoretically unlimited volume of sales into the market, driving down a company's shares. Instead of hoping a stock will fall, like a traditional short seller, an unscrupulous naked short seller may be able to help make it happen.

Overstock com CEO **Patrick Byrne** says naked short sales warp the market price of companies.

"If they don't have to borrow shares, there's nothing that keeps someone from selling and selling and hammering the market with sell orders," says Leslie Boni, a former University of New Mexico finance professor who studied naked short selling as a visiting scholar at the SEC in 2003 and '04. "They can overwhelm the number of buyers, and as the buyers dry up, the price keeps dropping."

When Movie Gallery's stock crashed on Feb. 3, short sellers sold almost 750,000 shares, or 11 percent of the shares traded that day, according to short-sale records compiled by Nasdaq. Daily short sales averaged almost 370,000 shares over the first eight days of February, up from 70,000 on Jan. 31, while the stock plunged 36 percent to $3.47 from $5.45. As the stock was falling, a growing number of sellers weren't delivering shares to buyers, a warning sign under SEC rules of possible naked short selling. Nasdaq put Movie Gallery on its list of companies at risk of manipulation because from trades through Feb. 8, those undelivered shares topped 160,000, or 0.5 percent of Movie Gallery's total shares. When companies surpass that threshold, SEC rules impose restrictions on further short selling.

'These people are lying, they're cheating and they're stealing,' a plaintiffs lawyer says.

Patrick Byrne, chief executive officer of Salt Lake City–based Overstock.com, has been the most vocal executive charging that abusive short-selling schemes are draining the lifeblood from many companies. "I've been pouring kerosene on myself and setting myself on fire because I think there are global, systematic issues with naked short selling," Byrne, 43, says. "It's warping the market price of some small-cap companies and destroying American entrepreneurship."

As of July 10, Overstock.com had been on Nasdaq's list of potential naked-short-selling targets every day since April 22, 2005, and its shares had fallen 45 percent over that period.

Investors who specialize in selling short say naked shorting is rare and complaints from supposed victims are overblown. "The phrase I would use would be red herring," says Jim Chanos, 48, who runs Kynikos Associates Ltd., a New York–based hedge fund firm known for short selling. He says he's never used naked short selling as a technique. "It sounds ominous, it sounds nefarious and, by and large, it's a nonissue in the marketplace," he says.

Wall Street traders have long thought that most complaints about naked short selling come from executives at poorly managed companies looking for a scapegoat when investors sour on their stocks, says Peter Chepucavage, a securities lawyer who has worked for the SEC and is now at Plexus Consulting Group LLC in Washington. "The Street's view is that this never was a real problem, and that these guys are whiners," he says.

Phillip Marcum, CEO of Denver-based Metretek Technologies Inc., says he doesn't need excuses for his company's performance and generally doesn't give short sellers a second thought.

DOUGLAS PIZAC/AP-WIDE WORLD

"We're a real company, with real investors and real revenue," says Marcum, 62, whose company sells commercial electricity-backup systems and meters to measure gas-well production. Metretek shares quintupled in the 12 months through the end of March, when the company announced a $28 million sale of additional stock.

Still, the American Stock Exchange on April 10 put Metretek on its list of potential naked-shorting targets because of an increase in shares that weren't delivered to buyers. On March 30, Metretek's shares fell almost 7 percent as sales rocketed to 169,000 shares from a daily average of 11,000 a week earlier.

"You can't control somebody who shorts stock," Marcum says. "But they've got to play by the rules. It seems to me, there ought to be severe penalties if you sell short without borrowing the stock. Can't they find out who's doing this and do something about these people?"

The short answer is no. The SEC puts most of its restrictions on brokerages, not naked short sellers. In one exception, SEC rules forbid naked short sales in connection with stock offerings. The SEC and exchanges have been investigating possible fraud in those instances. "This is an area where we have seen problems, and you can expect enforcement actions," said Susan Merrill, the New York Stock Exchange's regulation enforcement chief, speaking to a securities industry conference in June.

In the past three years, the SEC has imposed a total of just under $24 million in penalties in five cases alleging that traders and investment firms illegally covered naked short sales using shares from stock offerings. Four cases were settled without admissions or denials of wrongdoing; the fifth is pending.

The reason company executives and short sellers debate the scope of naked short selling is partly because there aren't statistics that specifically measure such transactions. New York-based Depository Trust & Clearing Corp., which processes the vast majority of U.S. trading, does keep track of how much stock has been sold and not delivered on schedule to the purchasers. On an average day in March, those unsettled trades amounted to more than 750 million shares in almost 2,700 stocks, exchange-traded funds and other securities, according to Depository Trust & Clearing data obtained from the SEC through Freedom of Information Act requests.

Because there are innocuous reasons why stock may not get to the purchaser on time, such as paperwork delays, it's impossible to tell how many of those shares, known as failures to deliver, can be blamed on naked short sales, Depository Trust & Clearing spokesman Stuart Goldstein says. "We're not in a position to know why trades fail," he says.

Failed deliveries of shares to buyers do provide the foundation for an SEC rule designed to blunt potential market manipulation. The measure is part of a broader package of short-selling rules known as Regulation SHO, for Short Sales. The rule, called Reg SHO, was approved unanimously in 2004 after almost five years of consideration under three SEC chairmen.

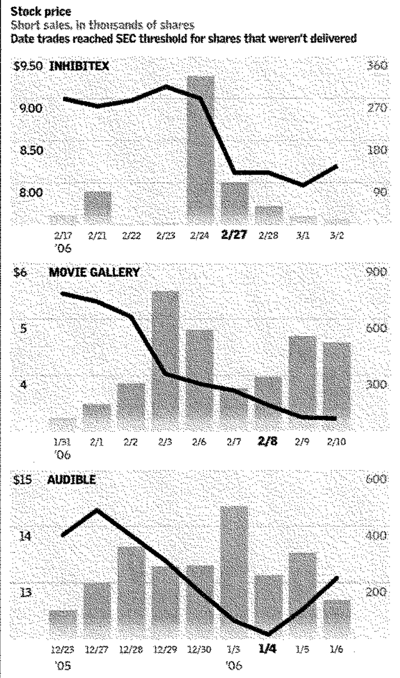
While Reg SHO doesn't outlaw naked short sales per se, it targets companies with enough failed deliveries to raise concerns about naked short selling, and it restricts further short sales of those stocks. Reg SHO's short-selling restrictions took effect in January 2005.

Reg SHO's naked-shorting provisions were designed to create a single SEC standard to replace individual rules that previously were set by each exchange. Supplanting exchange rules with one regulation meant the SEC, and not just market regulators, could police enforcement, says lawyer Chepucavage, 58, who helped draft Reg SHO. "There was a belief that the markets weren't aggressive enough in enforcing the rules," he says. "They tended to treat them as traffic ticket-type cases."

Under the SEC rule, Nasdaq, the NYSE, the American Stock Exchange and smaller markets must get daily reports

The plunge

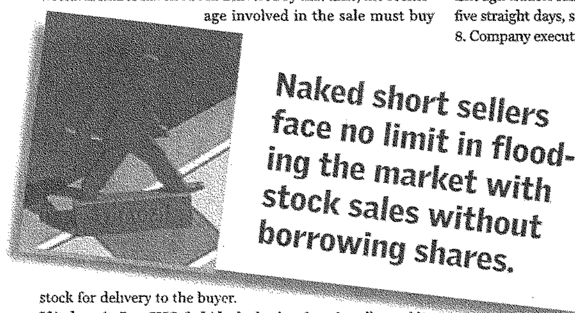
Naked short sales may have driven down share prices before stock exchanges recognized that buyers weren't getting the shares they had bought.



Sources: Bloomberg, Nasdaq

from Depository Trust & Clearing about failed deliveries. When an exchange finds that a company has accumulated unsettled trades equal to at least 10,000 shares and 0.5 percent of outstanding stock for five consecutive trading days, it's subject to stricter requirements for future short sales. Exchanges keep the companies on these lists until failed deliveries fall back below the 0.5 percent level for five straight trading days.

Once a stock is on a list, Reg SHO requires any new short sales to be settled within 13 trading days, about 2½ calendar weeks. If shares haven't been delivered by that time, the brokerage involved in the sale must buy stock for delivery to the buyer.



If it doesn't, Reg SHO forbids the broker from handling additional short sales of that company's shares unless it makes binding arrangements to borrow the necessary stock. During June, more than 425 companies were on an exchange list.

For the first year after the restrictions took effect in January 2005, the markets' lists suggest that Reg SHO cut down potential naked shorting. This year, the number of possible naked short sales has increased. From February through May, the average lists reported more stocks than in any month since August 2005. The number of new companies that surpassed Reg SHO's thresholds for the first time also jumped in February, to an average of 18.5 from as few as 15 in October 2005.

Depository Trust & Clearing's statistics on total failed deliveries of shares to buyers show a similar trajectory: In February and March, more than 700 million shares that were sold were not delivered to buyers on an average day, the highest levels since December 2004, the month before Reg SHO took effect.

Shares of Inhibitex Inc., a biotech drug developer in Atlanta's northern suburb of Alpharetta, plummeted 9.8 percent on Feb. 27, their biggest one-day drop in more than 14 months and the worst showing among more than 160 stocks in the Nasdaq Biotech Index. Nasdaq short sale records show that, during the two days ended on Feb. 27, short sellers traded almost 410,000 shares, up from fewer than 9,500 over the two preceding days. Enough traders failed to deliver stock over Reg SHO's limit for five straight days, so Nasdaq put Inhibitex on its list on March 8. Company executives didn't return calls seeking comment.

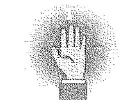
Audible Inc., which sells audio newspapers and books on the Web, had delivery failures that broke Reg SHO's threshold from trading on Jan. 4. Over five days, short sales had averaged 309,000 shares, almost triple the level for the preceding week. Audible, based in Wayne, New Jersey, ranked last in the 279-member Russell 2000 Technology Index during that stretch, falling 15.5 percent. "When you're manipulating the stock, you're taking away from investors, the business itself and our employees," says David Joseph, 37, an Audible vice president.

These apparent short sale jumps were allowed by a snag in Reg SHO. Under the rule, delivery deadlines apply only to short sales made after a company appears on one of the markets' lists. Naked shorting before that point, including the trades that put a company over the rule's thresholds in the first place, can remain unsettled indefinitely. "It's a loophole which allows an unlimited number of fails against anybody," says Robert Shapiro, an economist and former U.S. undersecretary of commerce, who is a consultant for Christian and other lawyers representing alleged victims of naked shorting.

On July 12, the SEC voted unanimously to propose changes to short sale regulations that would remove that clause and set deadlines for settling trades before a stock is added to

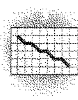
Empty-handed

In a traditional short sale, the trader must pay to borrow stock. A naked short seller avoids that expense by never borrowing shares and can drive prices lower.

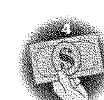


Trader sells shares he doesn't have for cash. **Doesn't borrow stock; avoids paying fee.**

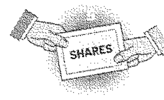
Buyer gets IOU promising stock will be delivered later.



Trader keeps selling stock he doesn't have, **pushing down price.** More buyers get IOUs.



After stock drops, trader pays lower price for shares to give buyers; **keeps extra cash as profit.**

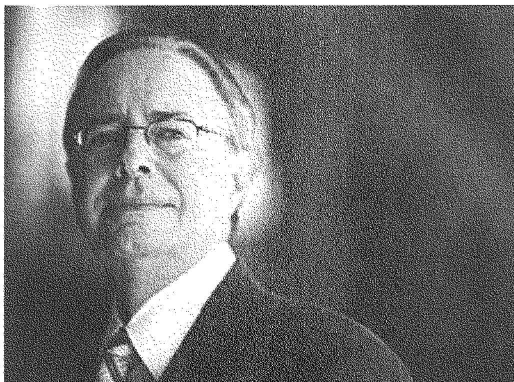


Trader uses shares bought at lower price **to replace IOUs.**

Source: Bloomberg

a threshold list. "There are still persistent failures to deliver in the marketplace, and some of that is undoubtedly attributable to loopholes in our rule," SEC Chairman Christopher Cox said.

The hole in the rule helps explain why some companies have stayed on the threshold lists for months or longer. As of July 17, New York–based Martha Stewart Living Omnimedia Inc., popular with short sellers since its eponymous founder's March 2004 trial and prison sentence for lying to federal investigators probing insider trading, had been on the NYSE's threshold list 383 times, or every day since Reg SHO took effect more than 18 months earlier.



Metretek CEO **Phillip Marcum** says severe penalties could stop naked short selling

Taser International Inc. had a 379-day streak on Nasdaq's list that ended on July 11. The stun gun manufacturer based in Scottsdale, Arizona, had faced an SEC probe of its accounting and product safety claims, and its shares fell 78 percent in 2005. The SEC ended its inquiry in May without bringing any charges. Krispy Kreme Doughnuts Inc., a one-time Wall Street favorite that fell from grace as the SEC investigated its accounting in 2004, was on the NYSE list for almost 18 months. Shares of the Winston-Salem, North Carolina–based company plunged 54 percent in 2005.

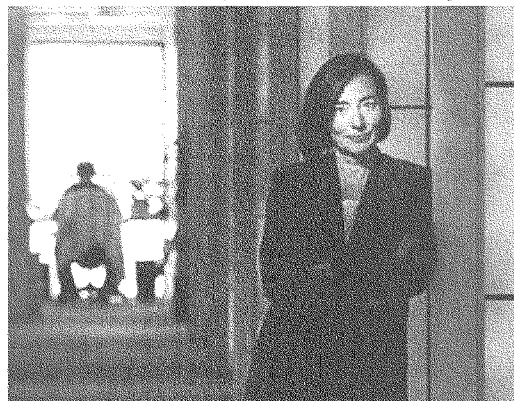
Taser and Krispy Kreme are typical examples of companies pounced on by short sellers after setbacks threaten stock prices. "There's no doubt some companies have issues other than stock manipulation," Christian says. "But they should be allowed to succeed or fail on their own and not because of manipulative market conditions. This is not just attributable to whining companies that couldn't make it."

The stakes in the debate were raised when an alliance of lawyers, including Christian, 53, and fellow Houston litigator John O'Quinn—a billionaire from fees in a $206 billion tobacco industry settlement—joined forces to represent companies alleging fraud in naked shorting. The group has already filed 14 lawsuits against short sellers, brokers and Depository Trust & Clearing and plans at least 20, Christian says.

A short sale begins, like other trades, when investors tell their brokers they want to sell stock. Reg SHO says a broker must check to make sure a brokerage or institutional investor has stock it's willing to loan the short seller in time for settlement, which for most U.S. stock transactions takes place three business days after a trade. After confirming the availability of stock loans, brokers send a sell order to the appropriate exchange, where shares are sold to investors who want to buy the stock. There's no law requiring short sellers to actually borrow shares.

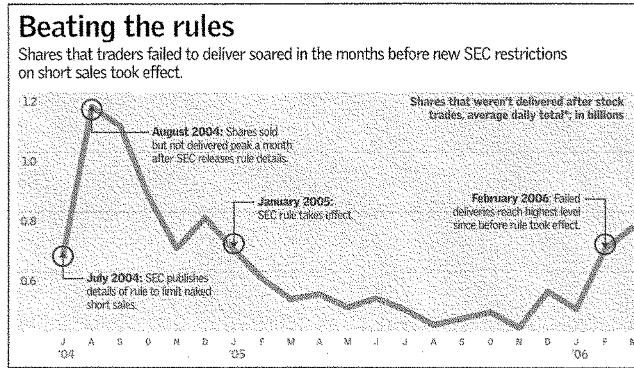
In a traditional short sale, buyers receive actual shares in a company. In a naked short sale, buyers effectively get an IOU promising that stock will be delivered at a later date.

When naked short sellers target a company, the results can be devastating, says David Vey, chairman of King of Prussia,



Leslie Boni, a former visiting scholar at the SEC, says naked short sellers can drive down stock prices by pumping the market with sell orders

DAVID STRICK; RAY NG (TOP)



*Figures represent shares from all trades that weren't delivered at settlement. Data counts only securities with at least 10,000 total failures to deliver.
Source: Depository Trust & Clearing data, released by the SEC under the Freedom of Information Act

Pennsylvania-based Sedona Corp., which sells software programs that help banks manage customer databases. "It's demoralizing when you're working hard and someone else is staying awake at night trying to figure out how to take your money," Vey says. In 2003, the SEC filed a suit alleging that a single naked short seller, Rhino Advisors Inc., a New York-based investment firm, accounted for 40 percent of all Sedona transactions during 21 days in March 2001. The short sales came after the company sold debt securities that could be converted into shares. The stock plunged from a high of $1.50 to as little as 72 cents in that period. Rhino settled the case in 2003 for $1 million without admitting or denying wrongdoing.

That kind of drubbing makes it difficult to attract new investors and capital and leaves potential customers wary, Vey says. "You have to prove credibility and some kind of staying power," he says. "People don't want to buy your product if they're worried you're not going to be here in two years." On July 10, Sedona shares closed at 21 cents in over-the-counter trading.

Depository Trust & Clearing's Goldstein, 55, says failed deliveries represent only a tiny fraction of U.S. stock trading, and naked short selling is one of many explanations for settlement delays. At the end of 2005, about 23,000 trades hadn't settled compared with about 26 million transactions on a typical day last year, Depository Trust & Clearing says. "We're not saying there is no problem, but to suggest the sky is falling might be a bit overdone," Goldstein says.

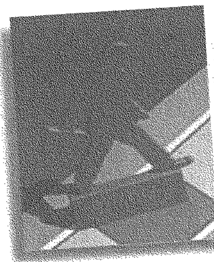
While there's more than one reason shares might not be delivered to buyers, Depository Trust & Clearing statistics for the days immediately after the SEC announced it would have new rules show that there could have been hundreds of millions of naked short sales. In eight trading days after the SEC released details of the new rule on July 28, 2004, failures to deliver skyrocketed 70 percent to more than 1 billion shares. They kept rising and, within a month, topped 2 billion shares.

The size and suddenness of that surge suggests it was caused by a rush of naked short sales rather than a rash of bookkeeping snags, Chepucavage says. "One might speculate that people were getting their naked short sales in before the rule took effect," he says. The rule's dependence on threshold lists was aimed at weeding out most of the clerical delays in stock sales that didn't produce shares at settlement, says Boni, 49, who's now a managing director at UNX Inc., a brokerage in Burbank, California.

Short sales and stock price movements for companies added to the SEC's lists, in some cases, recall an old saying: Just because you're paranoid doesn't mean that someone's not out to get you.

In April, Z-Trim Holdings Inc., which makes a calorie-free fat substitute for processed foods, hired lawyers Christian and O'Quinn to investigate whether naked short sellers sold shares of the company, which is based in the Chicago suburb of Mundelein. Reg SHO data show that Z-Trim, then known as Circle Group Holdings Inc., was placed on the American Stock Exchange's threshold list on March 3, 2005, reflecting failed deliveries from trading through Feb. 22. Over five trading days, daily short sales climbed to almost 40,000 shares on Feb. 22, from 3,300 a week earlier, while Circle Group's stock fell 24 percent to 76 cents from $1.

"Stock manipulators can cause huge losses for real people who invested real money," Z-Trim CEO Gregory Halpern says. The company retained lawyers to try to protect its



'Naked short selling has been a bogeyman,' one CEO says. 'Everybody thought it was out there.'

investors, he says. "We aren't sitting here complaining that our stock was manipulated, woe is me," Halpern, 48, says. "But having been thrust into that battle, we're going to fight like hell, because we have a responsibility to our shareholders."

For Dallas-based business software maker I2 Technologies Inc., threshold-busting trades occurred on Sept. 30, 2005, when short sales more than doubled to 51,000 shares from 21,000 the previous day. I2's shares fell 10.1 percent to $18.64 from $20.73. That was the stock's worst day in almost eight months and the third-biggest decline in the 575-member Nasdaq Computer Index. Company executives declined to comment.

Meanwhile, companies continue to see shares tumble under possible pressure from naked short sales. A month after Movie Gallery's stock collapsed in February, the company's investors had an even worse day, on March 8, after the company met with lenders about revising restrictions regarding loans. Over two days, shares fell more than 34 percent, while short sales averaged 2.5 million shares—up from an average of 300,000 during the previous week. Trading on March 8 created enough failed deliveries that Movie Gallery was again added to Nasdaq's threshold list.

Cromwell Coulson, CEO of New York-based Pink Sheets LLC, which runs a market for over-the-counter stocks, says making more information public about short sales is a key to fighting abuses, particularly for investors and executives in small companies. For example, under a new NASD rule, Nasdaq's threshold lists in July started including failures to deliver for shares of some small, over-the-counter companies that weren't covered by Reg SHO. Nasdaq also began including OTC Bulletin Board and Pink Sheets companies in monthly short-interest reports in July.

"Naked short selling has been a bogeyman; it was like Bigfoot," Coulson, 40, says. "Everybody thought it was out there, but nobody knew for sure."

Sedona's Vey says regulators at the SEC and each stock market need to hit some abusive traders with multimillion-dollar fines. "They need to make a few examples out of people," he says. Until penalties are big enough to take the profit out of stock manipulation, he says, all the rules and procedures in the world will make no difference. ➧

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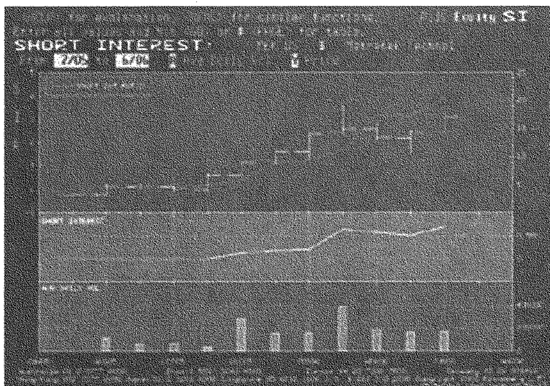
BLOOMBERG TOOLS

Tracking Short Interest

You can use the Short Interest (SI) function to track short positions in a selected stock that's traded on the American Stock Exchange, the Nasdaq Stock Market, the New York Stock Exchange or the Toronto Stock Exchange. For example, to track short interest on Metretek Technologies, type MEK US <Equity> SI <Go>, as shown below. The top graph shows the short interest ratio, which is the short interest—the total number of shares sold short that have not yet been repurchased—divided by the average daily volume over the selected period. SI also graphs short interest and average daily trading volume data.

For news stories related to short interest, type NI SHI <Go>. Type NI THRESHOLD <Go> for daily lists of Amex, Nasdaq and NYSE "threshold securities," stocks that have cumulative unsettled trades of 10,000 or more shares that are worth 0.5 percent or more of the shares outstanding for five consecutive trading days. Type SIUSNASD <Index> GP <Go> for a graph of an index that tracks Nasdaq short interest.



You can use the Bloomberg Law Search (BBLS) function to search for cases related to naked short selling. Type BBLS <Go>, and click on United States under Sources. Click on Courts and then on All Courts to select it. Enter *NAKED SHORT* in the ENTER TERMS field, and click on the Search button.

JON ASMUNDSSON

For other stories by Bob Drummond, type BOB DRUMMOND <Help> 7 <Go> 1 <Go> 3 <Go>.

BOARD OF GOVERNORS
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SUSAN SCHMIDT BIES
MEMBER OF THE BOARD

December 14, 2006

The Honorable Vito Fossella
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my responses to your additional questions in connection with the hearing on "A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate." I have also forwarded a copy of my response to the Committee on Financial Services for inclusion in the hearing record.

Sincerely,

Susan Schmidt Bies

Enclosure

Governor Susan Schmidt Bies subsequently submitted the following in response to questions received from Congressman Fossella in connection with the September 14, 2006, hearing before the House Subcommittee on Financial Institutions and Consumer Credit:

1. **It is my understanding that on the current schedule, internationally-active U.S. banks won't have Basel II in place until 2012 at the earliest, while Basel II is final everywhere else. There are many projecting that an increase in merger activity in the EU will result from Basel II. Given the lag time between countries abroad and the U.S., do you anticipate a potential consequence will be a lot of takeovers of U.S. banks by non-U.S. companies?**

   Or in more general terms, broader terms, please comment on the impact you believe capital has on consolidation and competition.

Answer: The financial services competitive landscape is influenced by a number of factors, including but not limited to regulatory capital requirements. As an example, U.S. banks maintain some of the highest capital ratios in the world, both from a regulatory capital and a GAAP tangible shareholders' equity perspective, and those same institutions consistently report some of the most robust profitability metrics in the world.

The Federal Reserve does not expect that the different Basel II implementation timetables of the United States and the EU will result in a material increase in the acquisition of U.S. banking organizations by EU banks (or vice versa). A decision by one financial institution to acquire another financial institution is seldom principally motivated by regulatory capital considerations– merger and acquisition activity in the banking sector is much more often motivated by the desire of banking organizations to increase market share in existing geographic markets, increase access to new geographic markets, create additional economies of scale, or broaden the scope of product offerings. Federal Reserve staff economists have studied the potential impact of Basel II on mergers and acquisitions activity in the U.S. banking sector. See below.

Beyond the timetable differences, the ultimate version of Basel II adopted in the United States will likely differ in a number of substantive ways from the EU's ultimate version of Basel II. National differences in capital regulation are not unique to the Basel II capital regime. The U.S. banking agencies currently impose a leverage ratio and Prompt Corrective Action requirements on U.S. banks that are more conservative than the Basel I capital accord, yet U.S. banking organizations are among the most profitable and competitive in the world. Nevertheless, early comments on the Basel II NPR suggest that, whatever the merits of these international differences in rules, they are likely to add to implementation costs and home-host issues, particularly for globally active banks operating in multiple jurisdictions. Before the Federal Reserve issues a final rule, we will look carefully at differences in the implementation of Basel II that may adversely affect the international competitiveness of U.S. banks.

Will the Proposed Application of Basel II in the United States Encourage Increased Bank Merger Activity? Evidence from Past Merger Activity

February 18, 2004

Timothy H. Hannan

Steven J. Pilloff

*Board of Governors of the Federal Reserve System. The views expressed are those of the authors and do not necessarily represent those of the Board of Governors of the Federal Reserve System or its staff. The authors would like to thank Robert Avery, Allen Berger, Nora Barger, Ed Ettin, Jim Follain, Diana Hancock, Erik Heitfield, Beverly Hirtle, Myron Kwast, Robin Prager and staff of the FDIC, OCC, and OTS for comments and suggestions, Shaista Ahmed, David Kite, and Onka Tenkean for excellent research assistance, and Cecilia Tripp for valuable secretarial help.

ABSTRACT

This paper presents two tests of the hypothesis that adoption of the internal ratings-based approach to determining minimum capital requirements, as proposed in applying the Basel II capital accord in the United States, will cause adopting banking organizations to increase acquisition activity. The first test estimates the relationship between excess regulatory capital and subsequent merger activity, including organization and time fixed effects, while the second test employs a "difference in difference" analysis of the change in merger activity that occurred the last time regulatory capital standards were changed. Estimated coefficients and observed differences have signs consistent with the hypothesis, but results are either statistically insignificant or imply differences that are small in magnitude.

I. Introduction

One of the most important elements of the proposed Basel II capital accord is the advanced internal ratings-based (A-IRB) approach to regulatory capital requirements. The A-IRB approach differs substantially from the Basel I approach and the proposed standardized approach in Basel II in that a banking organization's internal assessments of key risk considerations serve as primary inputs in the calculation of capital requirements. Because the A-IRB approach is based on banks' internal assessments using systems validated by supervisors, it offers the benefit of more risk-sensitive minimum regulatory capital requirements. Those banking organizations using the A-IRB approach will be required to employ sophisticated risk-measurement techniques that involve a statistical and quantitative assessment of risk.

Under the current proposal for banking organizations in the United States, organizations with total banking (and thrift) assets of at least $250 billion or at least $10 billion in on-balance-sheet foreign exposure–about ten large organizations based on current balance sheets–would be required to adopt A-IRB. Other banking organizations may also choose to adopt A-IRB, provided they have developed the necessary infrastructure to measure and manage risk. While any bank may "opt in" if it meets regulatory standards, only a few of the largest U.S. banking organizations initially will have in place the infrastructure required to employ such techniques, implying that the A-IRB approach will be used at the outset only by a small group of the largest banking organizations. The result would be a bifurcated system in which the vast majority of

banking organizations would be subject to the current minimum capital regulations in this country, essentially based on Basel I, while the largest banking organizations would be subject to the more risk-sensitive and flexible method of determining minimum regulatory capital requirements. It is anticipated that a number of larger banking organizations would join the initial set relatively soon after the implementation date.

While this bifurcated system may raise the regulatory capital requirements for some A-IRB banks, it is likely to result in somewhat lower minimum regulatory capital requirements, on average, for the banking organizations that can avail themselves of this approach, relative to the minimum regulatory capital requirements applied to the vast majority of banks that initially cannot.[1] Concerns have been raised that this disparity would provide an undue competitive advantage to many of the largest banking organizations in the country. Furthermore, concerns have been raised that both the excess regulatory capital that would be created at A-IRB organizations as a result of reduced capital requirements and the aforementioned competitive advantage associated with those reduced requirements would fuel their acquisitions of non-adopting banking organizations. Such concerns have not been the subject of empirical examination. In this paper, we bring data to bear on the second of these concerns: that BHCs that adopt A-IRB will

[1]See the Third Quantitative Impact Study, which was conducted by the Basel Committee on Banking Supervision to understand the possible effects that the Basel II proposals (as of late 2002) might have on capital levels across participating banks. The document can be found at www.bis.org/bcbs/qis/qis3.htm. Another quantitative impact study is planned for the second half of 2004.

aggressively acquire other banking organizations.[2]

There are two primary consequences of the A-IRB approach to capital requirements that suggest to some observers that A-IRB BHCs would increase acquisition activity. Arguments based on these consequences may be usefully designated as "excess regulatory capital" and "relative capital advantage" arguments.

"Excess regulatory capital" arguments assert that merger activity would increase as a result of the excess regulatory capital that would be created by the lower capital requirements stemming from adoption of A-IRB. Excess regulatory capital could fuel acquisitions for a number of different reasons. For example, a BHC desiring to engage in a certain acquisition may be deterred under current capital requirements, because the merger might cause the combined entity to violate existing capital standards. However, a reduction in regulatory requirements and a consequent increase in excess regulatory capital might encourage the acquisition by significantly reducing the likelihood of the combined BHC failing to meet the new, more lenient capital standards.

Another example of an "excess regulatory capital" argument is that, with an increase in excess regulatory capital, BHCs could increase their return on equity (ROE) by increasing the amount of earning assets against which a given amount of capital is held (or reducing capital held against a given amount of earning assets). Increased ROE may in turn raise BHC valuation, which could facilitate an increase in acquisition activity.

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[2]Several other studies that look at the competitive effect of A-IRB on specific products are being conducted by Federal Reserve economists.

The focus of "relative capital advantage" arguments is on the difference in the capital standards applied to A-IRB BHCs and other banking organizations, maintaining that lower capital requirements for BHCs operating under A-IRB, relative to those of banking organizations operating under existing standards, would result in increased acquisition activity. Specifically, it is alleged that A-IRB BHCs would have an incentive to acquire banks not subject to A-IRB capital standards because target banks would be worth more to A-IRB BHCs than to current owners. Different valuations would exist because A-IRB BHCs are expected to face regulatory capital requirements that would be lower than those of the banking organizations that they might acquire. Consequently, they could acquire such organizations and increase the return on equity associated with the acquired assets by either increasing income-earning assets without adding capital or holding less capital against the newly acquired assets.[3]

Both "excess regulatory capital" and "relative capital advantage" arguments rely on the assumption that current regulatory capital requirements are "binding" in the sense that large banking organizations are restricted from doing what they would otherwise do in the absence of current minimum capital regulations. Regulatory capital requirements would

[3]Although other arguments for a positive relationship between A-IRB status and acquisition activity can be made, we believe that the primary reasons that acquisition activity may be affected by A-IRB depend on "excess regulatory capital" and the "relative capital advantage." An example of an alternative explanation is that the market values the improved ability to measure and manage risk associated with adopting A-IRB, thereby raising the valuation of A-IRB BHCs and enabling them to increase their acquisition activity. In addition, the costs and benefits associated with the A-IRB approach could influence decisions by banks not using the A-IRB approach to merge with each other. This study does not examine the effect of A-IRB on mergers of this type.

not be binding if market-based considerations dictated higher levels of capital than those imposed by regulation, or if, as some have argued, "capital arbitrage" techniques currently employed by the larger banking organizations allow them largely to avoid, with minor costs, the constricting effects of existing minimum regulatory capital requirements.[4]

Ultimately, the question of whether, in the United States, adoption of the bifurcated application of Basel II would result in a substantial increase in merger activity by banking organizations using the A-IRB approach must be assessed by examining relevant data. The best approach, were it available, would be to examine the results of previous reductions in regulatory capital requirements that applied to some banking organizations but not to others, and assess whether substantial relative increases in the acquisition activity of those granted the reduction occurred as a result of the change. Unfortunately, no such reduction in capital requirements has taken place in recent decades. Therefore, we must assess the issue by pursuing less definitive, but nonetheless informative, approaches.

Specifically, we conduct two different types of tests. The first type uses recent data on merger activity and BHC capital ratios to determine if, all else equal, large banking organizations with greater excess regulatory capital exhibit a greater tendency to subsequently acquire other banks. Such a finding would be consistent with the argument that allowing large BHCs to operate under lower capital requirements (and thereby

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[4]See Jones (2002) for a detailed discussion.

increase excess regulatory capital) would result in expanded acquisition activity on their parts. This approach, however, is subject to several sources of potential endogeneity bias, only some of which are eliminated by the fixed-effects statistical procedure that we employ.

In part for this reason, we also conduct a test based on observations of what happened the last time that capital standards changed substantially for banks. It is argued that the advent of "prompt corrective action" (PCA) standards in the early 1990s increased capital requirements for banks, a change that was in the opposite direction of the reduction of regulatory minimum capital requirements that is expected to occur, on average, for BHCs that adopt the A-IRB approach.[5] Taking a sample of large BHCs that did not appear to be constrained by the capital requirements in effect before the advent of PCA, and, further, would not have been constrained under the pre-PCA capital standards after the adoption of PCA, we compare the change (from the period before to the period after PCA) in merger activity exhibited by those BHCs that did and did not become capital constrained after more stringent regulatory capital standards became relevant. A finding that BHCs constrained by the advent of PCA standards reduced their merger activity by more (or increased it by less) than those not so constrained would be supportive of the hypothesis that relaxation of regulatory capital requirements (as anticipated, on average,

[5]Although the capital standards of "prompt corrective action" are relevant for banking institutions, not bank holding companies, the amount of capital held by bank holding companies should be affected by the "prompt corrective action" standards.

for BHCs that adopt the A-IRB approach) would result in greater merger activity by A-IRB BHCs.

Our tests are more relevant to the "excess regulatory capital" arguments for increased merger activity by A-IRB banking organizations than for "relative capital advantage" arguments. However, as discussed below, a number of studies have been conducted that are not supportive of "relative capital advantage" arguments. The results of this literature uniformly reject the hypothesis that acquirers seek to purchase more highly capitalized targets–a finding that is not consistent with the notion that acquirers prefer targets with greater potential for ROE improvement from increased leverage.

Still, the use of historical data in previous studies and in the current paper limits our ability to capture the extent to which future acquisition activity might occur as a result of the "relative capital advantage" associated with A-IRB. Further, it restricts our ability to address the possibility that acquisitions driven by different capital standards would be most likely to occur in the case of targets holding assets that require much less capital under A-IRB. However, several forthcoming studies by Federal Reserve economists will assess whether A-IRB status would be likely to provide adopters with a substantial competitive advantage in the provision of loans to small and medium size enterprises, loans for residential mortgages, and credit card loans. The results of these studies will be important in assessing how acquisition activity could change as a result of the "relative capital advantage" associated with A-IRB.

The plan of the paper is as follows. Section II discusses the literature relevant to

the relationship between bank merger activity and capitalization. Section III describes the proposed empirical tests, section IV describes the samples, data, and variables, and section V presents empirical results. A final section summarizes and concludes. To preview results, we do not find convincing evidence that past levels of excess regulatory capital or past changes in capital requirements have had a substantial effect on merger activity. Results of the two tests suggest relationships that are in the direction consistent with the concern that a reduction in minimum capital requirements for large banking organizations that adopt A-IRB would result in increased merger activity on their part, but, with a few exceptions, results are not statistically significant. When results are statistically significant, relevant magnitudes are found to be quite small.

II. Relevant Literature

A very large literature has addressed the question of why banking organizations acquire other banking institutions.[6] Several reasons that banks merge have emerged from this literature, and these same reasons are also commonly cited by bankers and other industry analysts. Specifically, the prospects for increased efficiency and potential gains from diversification are noted as the key drivers of acquisition activity. Moreover, of particular importance to the U.S. banking industry, relaxation of longstanding interstate banking restrictions is widely believed to have sparked extensive consolidation of an

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[6]For comprehensive reviews, see Berger, Demsetz, and Strahan (1999) and Group of Ten (2001), available at www.bis.org.

industry that was decentralized for over one hundred years. Interestingly, capital is rarely cited as an important issue in the question of why banks merge. Indeed, few studies have sought to investigate the role of capital, especially that of the acquirer's capitalization relative to regulatory requirements. The scarcity of such studies likely reflects the belief that such considerations play a minor role at best in explaining mergers in the banking industry.

The only study that we know of to investigate the acquiring institution's capitalization as a determinant of merger activity was conducted by O'Keefe (1996), who found that acquirers in the large sample of banks that he investigated had significantly *lower* equity capitalization rates than their nonacquiring peers. Because it suggests that better capitalized banks are less likely to acquire other banks, this finding does not support "excess regulatory capital" arguments that banking organizations, holding increased excess regulatory capital as a result of reductions in minimum regulatory capital requirements, would increase the rate at which they acquire other banking organizations. O'Keefe's sample, however, is not restricted to the very large bank holding companies of concern in this study, so this finding may have limited relevance to the behavior of the BHCs that adopt A-IRB.

Several studies report evidence relevant to "relative capital advantage" arguments, which our empirical tests do not address very directly. These arguments, as noted above, assert that, with lower capital requirements than those of their potential targets, A-IRB BHCs would have an incentive to acquire these better capitalized targets and increase the

return on equity associated with target assets by reducing the capital held against those assets. An implication of this argument for past merger behavior is that acquirers should have found more highly capitalized banks relatively more attractive as acquisition targets.

A fairly large number of studies report results that contradict this implication. We know of at least five studies–Hannan and Rhoades (1987), Amel and Rhoades (1989), O'Keefe (1996), Moore (1997), and Wheelock and Wilson (2000)–that sought to determine the characteristics of banking organizations that make them more likely to be a target in a future bank acquisition and that also included the bank's capitalization as a potential determinant. Using various time periods and various samples, all of these studies find that more highly capitalized banks are *less* likely, not more likely, to be acquired, all else equal. Although the reason for this uniform finding is ambiguous, the finding is clearly not consistent with the "relative capital advantage" argument.

Another study, by Houston, James, and Ryngaert (2001), addresses in a different way the role of capital as a motivation for bank mergers. As a part of their study, the authors obtained from both managers and analysts opinions and, in some cases, estimates of the sources of expected merger-related gains. Of the 41 mergers on which such information could be obtained, capital structure benefits were noted in only five cases. In four of these cases, analysts noted that the merger might enable the combined bank to free up excess capital, a benefit that would be consistent with "relative capital advantage" arguments. However, because capital is cited in such a small share of the acquisitions in their analysis, their findings seem to suggest that capital has not played a major role in

explaining why banks make acquisitions.

III. Empirical Tests

Test 1. Our first test requires estimation of the relationship between BHC capitalization and subsequent BHC merger activity, using data obtained for recent years. The rationale for this test rests on the presumption that some banking organizations in the recent past have, for whatever reason, found themselves in the position of having capital in excess of the level that they would hold because of regulatory capital requirements, while other banking organizations have found themselves with no such excess and thus may have been constrained by regulatory capital requirements.

The level of capital that BHCs feel bound to maintain because of regulatory requirements may include some additional "cushion" above the required regulatory minimums. Such cushions may be maintained for protection against poor performance or other unanticipated events, and the size of this cushion may differ from one BHC to another, depending on the BHC's risk and other factors.[7]

With this in mind, we seek in this test to determine if BHCs that find themselves with excess regulatory capital exhibit a greater subsequent tendency to acquire other banking organizations than do BHCs that are more constrained by regulatory

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[7]There is ample evidence that most BHCs chose to maintain some kind of cushion or buffer above minimum regulatory requirements and that its size depends on portfolio characteristics and other factors. See, for example, Hancock and Wilcox (2002).

requirements. The finding of a positive relationship between observed capital ratios and merger activity or the finding of a discreet increase in merger activity at some level of capitalization representing a plausible critical level, would be consistent with the predictions of "excess regulatory capital" arguments that relaxation of capital constraints leads to more merger activity.[8]

A point that bears emphasizing, however, is that if the level of capitalization required by the market were greater than that dictated by regulation, or, equivalently, if capital arbitrage allowed BHCs to circumvent regulatory capital requirements with little cost, then there would be little reason to expect a relationship between excess regulatory capital and merger activity.

We can test for this hypothesized relationship by estimating the following relationships:

$$M^i = \beta_0 + \beta_1 (K/A)^i + \beta_2 X + \varepsilon_i \text{, and} \quad (1)$$

$$M^i = \alpha_0 + \alpha_1 KA1 + \alpha_2 KA2 + .. + \alpha_n KA\text{n} + \alpha_{n+1} X + \mu_i , \quad (2)$$

where M^i denotes the level of merger activity of BHC_i, $(K/A)^i$ denotes its capital asset ratio, and $KA1$, $KA2$,...KAn denote binary variables that receive values of 1 if $(K/A)^i$ is in a

[8]An increase in capital could lead to less, rather than more, merger activity if BHCs with low capital ratios engage in greater acquisition activity than better capitalized BHCs. This could occur because weakly capitalized organizations may purchase highly capitalized targets to increase the capitalization of the combined entity, relative to the pre-merger acquirer. If raising capital levels is a motivation for some mergers, then test results will reflect these mergers, which could obscure the effect of acquisition activity that was conducted for reasons consistent with "excess regulatory capital" arguments. To the extent that such differing types of mergers take place, we believe that results that reflect the average mix of these different types of mergers are the most relevant for understanding the potential effects of A-IRB.

defined range of values and zero otherwise. Equation (1) imposes a linear relationship between M^i and $(K/A)^i$, while equation (2) allows the relationship to vary across different ranges of $(K/A)^i$ but not to vary within those ranges. The vector X denotes other explanatory variables that may influence observed merger activity, and ε_i and u_i denote error terms. Finding that $\beta_1>0$ in estimations of (1) would be consistent with the hypothesis that merger activity increases with capitalization (and equivalently, excess regulatory capital), and finding that coefficients on *KA*1, *KA*2, ..., *KA*n are positive and increasing in magnitude as capitalization increases would also be consistent with the hypothesis.

If, as noted above, different BHCs set different cushions above the regulatory minimum, estimates of (2) could not be used to identify some critical level of capital below which BHCs are constrained. Under these circumstances, a given binary variable might correctly classify one BHC as not being bound by regulatory requirements, while incorrectly classifying another BHC that was, because of a higher cushion, in fact constrained by such requirements.

Biased estimates attributable to various forms of endogeneity are an important concern in assessing the results of estimations of (1) and (2). Any unobservable characteristic of BHCs that influences both the propensity of a BHC to acquire other banking organizations and its capitalization would impart a bias to the relevant coefficients. To reduce, but unfortunately not eliminate, this possibility, explanatory variables are calculated either for the year prior to that for which merger activity is

measured, or, in the case of balance sheet variables, at the beginning of the year for which merger activity is measured. More importantly, (1) and (2) are estimated using panel datasets consisting of annual observations of large BHCs over two time periods: The first, from 1998 to 2002, is designed to obtain the benefits of panel data estimation using only the most recent (and relevant) five years of available data. A second and longer period, from 1993 to 2002, is also used, since it allows for more annual observations of merger activity and capitalization.

Reported estimations incorporate both year and BHC fixed effects. This approach, in essence, controls for all BHC-specific characteristics that do not vary over time and for all time-specific characteristics that do not vary across BHCs. The inclusion of BHC fixed effects in particular eliminates potential sources of spurious correlation that might arise in comparing one BHC with another.

Spurious correlations in the form of endogeneity bias may result, however, if a time varying unobserved variable influences both a BHC's merger activity and its level of capital (or excess capital) over time in a way different from its effect on other BHCs in the sample. This type of correlation would exist, for example, if BHCs intent on making acquisitions first increase capital levels. The existence of such a correlation between merger activity and measures of capital would bias upward estimates of the coefficients on measures of capital (or excess regulatory capital), resulting in estimates that would overstate the actual expected change in merger activity that would accompany a change in

capital requirements.[9]

Test 2. The second test that we conduct should not be as vulnerable to endogeneity bias but requires that we go back considerably in time to assess the impact on merger activity of a previous change in capital requirements. Specifically, we look at the effect on merger activity attributable to the adoption of more restrictive capital standards. Passed into law in December 1991 and fully implemented at the end of 1992, the "prompt corrective action" (PCA) provisions of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, by all accounts, increased capital adequacy requirements for commercial banks and made more certain that failure to meet them would result in sanctions.

In this second test, our strategy, roughly stated, is to examine the change in merger activity exhibited by large BHCs before and after PCA provisions became relevant. We restrict the sample to those BHCs that met the pre-PCA capital requirements both before and after the PCA standards became relevant. These conditions are imposed to determine whether BHCs that became constrained only because of the new capital requirements (and not for other reasons that may entail endogeneity bias) decreased their merger activity by more (or increased it by less) than those BHCs that were not constrained by the new

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[9]Another example might be an improvement in a local economy that resulted in an increase in both the merger activity and excess capital of BHCs located in the relevant area but that had no or less influence on BHCs not located in the area. This would impart a positive bias to the coefficients of the measures of excess capital in the regressions reported below. To control for this possibility, we include a measure of local economic health in the analysis.

requirements.

A positive answer to the question of whether constrained BHCs decreased their acquisition activity relative to unconstrained BHCs would be consistent with the hypothesis that "binding" or constraining capital requirements reduce merger activity. More relevant to the question at hand, it would be consistent with the hypothesis that relaxation of regulatory capital requirements, to the extent that they are binding or constraining, would result in an increase in merger activity.

A more formal derivation of the test is presented as follows: Suppose that before the advent of PCA, the relationship between the merger activity of a typical, large BHC and its capitalization can be expressed as:

$$M_i^b = \beta_o^b + \beta_1 KADUM^b + \beta_2 X^b + \varepsilon_i^b, \qquad (3)$$

where the superscript "b" denotes that the variable or coefficient pertains to the period before PCA, $KADUM^b$ is a binary variable that receives the value of one if capitalization was less than the level at which regulatory capital requirements in that period became binding or constraining, and zero otherwise, and ε_i^b denotes the error term. The major feature of this specification is that it allows a discrete difference in merger activity for BHCs that do and do not face binding capital constraints.

We posit the same relationship after PCA, expressed as:

$$M_i^a = \beta_o^a + \beta_1 KADUM^a + \beta_2 X^a + \varepsilon_i^a, \qquad (4)$$

where the superscript "a" refers to the period after adoption of PCA standards, with all

variables defined as in (3).

Note that coefficients are presumed to be the same in (3) and (4), consistent with the underlying "natural experiment" rationale for the test, which is that only regulatory capital requirements, and not underlying relationships between acquisition activity and explanatory variables changed between periods. There appears to be little reason to expect changes in regulatory minimums to affect these underlying relationships between merger activity and its determinants. Importantly, $KADUM^a$ is a binary variable that receives the value of one if capitalization is less than the critical value of capitalization under PCA. If this critical value is higher than that which was relevant in the earlier period, then we will observe some BHCs for which $KADUM^b$=0 and $KADUM^a$=1, despite little or no change in capitalization. In other words, there will be some BHCs that were not constrained before the introduction of PCA standards, but became constrained as a result of that introduction.

Subtracting (3) from (4) yields:

$$M_i^a - M_i^b = (\beta_0^a - \beta_0^b) + \beta_1(KADUM^a - KADUM^b) + \beta_2(X^a - X^b) + (\varepsilon_i^a - \varepsilon_i^b) \qquad (5)$$

If determinants of merger activity other than those associated with a binding capital requirement are either invariant over time, (in which case $X^a = X^b$) or, as with variables reflecting the macroeconomic environment, the same across BHCs over the time period, then the term $\beta_2(X^a - X^b)$ in (5) is either zero or subsumed into the constant term. Under these conditions, only β_1, $KADUM^a$, and $KADUM^b$ explain differences between the two groups of BHCs in the change in merger activity before and after PCA. It follows that

$(KADUM^a\text{-}KADUM^b)=1$ for the case of a BHC that was not constrained by capital requirements before PCA but was constrained afterwards, and that the term $(KADUM^a\text{-}KADUM^b)=0$ for BHCs that were not constrained in either period.

If $\beta_1<0$, which is implied if constrained BHCs engage in less merger activity than unconstrained ones, then we have the simple prediction that, of those BHCs believed to be unconstrained by capital requirements prior to PCA ($KADUM^b=0$), the BHCs that became constrained after the change to tougher capital standards ($KADUM^a=1$) should have experienced a greater reduction (or smaller increase) in merger activity than those BHCs that remained unconstrained after the change ($KADUM^a=0$). This prediction follows because the only remaining term (except for the constant) in (5), given these assumptions, is: $\beta_1(KADUM^a\text{-}KADUM^b)$, and, with $\beta_1<0$, this term is negative for banking organizations constrained by PCA and zero for those that are not.

Under the assumptions discussed above, this prediction may be tested with a straightforward comparison of the change in merger activity across the two groups. This test has the benefit of focusing on the effect of an actual past change in capital standards, and it offers well known advantages associated with this "difference in difference" methodology. Among these advantages, all of the numerous differences in BHCs that might influence merger activity and that do not change over the comparison period "cancel out." Further, because the changes in merger activity for the two groups are calculated for the same time period, the effects of macroeconomic and other changes over time (as long as they influence the two groups equally) are fully controlled for. While these simplifying

assumptions appear reasonable, tests based on full estimations of (5) are also conducted.

IV. Samples, Data, and Key Variables

Samples employed in the analysis consist of the largest U.S. BHCs (based on total assets as of mid-year 2003) that operated throughout the period under investigation. Two successively larger samples of BHCs that operated between year-end 1991 and mid-year 2003 are used in test 1 (panel data analysis). The more restrictive sample includes the ten U.S. banking organizations that are expected to be required to adopt A-IRB status under the current proposals. These organizations are referred to as the mandatory A-IRB BHCs. The first sample also includes the nine other U.S. BHCs with total assets of at least $50 billion as of mid-year 2003, since they are considered most likely to adopt voluntarily the A-IRB approach in the initial implementation phase. The second and larger sample includes the ten mandatory A-IRB BHCs plus all other U.S. BHCs with total assets of at least $15 billion as of mid-year 2003. This results in a sample of 38 BHCs and includes a large number of banking organizations that are likely to eventually adopt A-IRB. Analysis is conducted on both samples over two different time periods: a shorter and more recent one covering the years 1998-2002 and a longer one covering the years 1993-2002.

The samples used in test 2 (the natural experiment) are the same as those used in test 1, except that BHCs must have operated between year-end 1986 and mid-year 2003. This requirement causes two BHCs to be dropped because they were not operating during the early part of the period. For reasons discussed below, the years 1987 to 1989 serve as

the pre-PCA period, while 1991 and 1992 serve as the post-PCA period.

Merger data were obtained from two sources. The SNL Financial Bank Mergers and Acquisitions Database was the primary source for data on deals that were completed after December 31, 1989. The SNL database includes the vast majority of acquisitions of banks (banks and bank holding companies) and thrifts (savings banks, savings and loan associations, and thrift holding companies) that took place during the period, which includes all of the time covered by test 1 (panel study) and the latter part of test 2 (natural experiment).

The SNL database is not used before 1990 because it is not very comprehensive for deals that took place during that time. Therefore, data for this earlier period were collected from another source. Mergers that took place in 1987, 1988, or 1989–the pre-PCA years needed for test 2–were identified from a database created by staff at the Federal Reserve Board from Federal Reserve Bulletins and reports provided by the Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC).[10] This database includes only acquisitions in which each party was either a commercial bank or a BHC that operated a commercial bank. Deals involving a thrift as the acquirer or target were not included. Therefore, to maintain consistency, mergers involving savings banks or savings and loan associations that took place after the adoption of PCA are dropped from the group of mergers identified on the SNL database. This

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[10]This database was the primary source for two extensive studies of bank merger activity in the United States. See Rhoades (2000) and Rhoades (1996).

requirement has little effect on the set of mergers included in the analysis.

We construct two variables that measure merger activity. The first is the annual number of mergers completed during the relevant period by a BHC. This variable measures the frequency with which a BHC pursued consolidation, not the size of acquisitions. It can be constructed for all years in our analysis and therefore is used for both test 1 and test 2.

A second merger variable that incorporates the size of the targets acquired by a BHC is also used for test 1. Data on the amount of banking assets acquired are available for all years included in test 1 and are used to construct a measure of the relative magnitude of acquisition activity that was conducted by each BHC in the sample. Specifically, the aggregate amount of banking assets acquired in a given year is divided by the BHC's asset level at the start of the year. By dividing by the BHC's total assets, we account for the size of that banking organization.

Capital ratios are constructed with data from the Y-9C report, which is filed quarterly by each BHC with the Federal Reserve Board and contains extensive accounting information on the organization. Creating variables that measure the extent to which BHCs faced capital constraints involves several challenges. First, during the full time period for which data are required (1986-2002), two distinct sets of capital requirements were in effect. Therefore, the capital ratios that are constructed must be those that were relevant at the time.

Capital requirements during the late-1980s predated the implementation of Basel I

and its associated risk-based capital rules. At the time, BHCs had to satisfy two requirements. First, the ratio of primary capital to assets had to be at least 5.5 percent and the ratio of total capital to assets had to be at least 6 percent.[11] We create variables that measure both the primary and total capital ratios that are consistent with these regulatory requirements.

The original Basel capital accord, or Basel I, was approved in 1988 and fully implemented by 1992. This accord established a new set of capital requirements that attempted to take risk into account. More specifically, less capital had to be held against assets that were considered safer, such as residential mortgages and inter-bank loans, as well as government and agency securities. BHCs had to satisfy two risk-based capital requirements and one leverage requirement. The ratio of tier 1 capital to risk-weighted assets had to be at least 4 percent, the ratio of total capital to risk-weighted assets had to be at least 8 percent, and tier 1 capital to average tangible assets had to be at least 4 percent. For each year that the Basel I requirements were in effect, we construct variables that correspond to each of these three capital ratios.

Legal limits represent the lowest level of capital that a BHC can maintain before

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[11]Primary capital for a bank holding company consists of common stock, perpetual preferred stock, surplus (excluding surplus relating to limited-life perpetual stock), undivided profits, contingency and other capital reserves, mandatory convertible instruments, allowance for possible loan and lease losses (exclusive of allocated transfer risk reserves), minority interest in equity accounts of consolidated subsidiaries, and perpetual debt instruments. Total capital consists of primary and secondary capital. This latter component includes limited-life preferred stock, as well as bank subordinated notes and debentures and unsecured long-term debt of the parent company and its non-bank subsidiaries.

violating regulatory requirements. However, as mentioned, BHCs are likely to prefer to hold a capital buffer above those regulatory limits for a variety of reasons. First, there are tangible benefits to being considered well or strongly capitalized. During the 1990s, the implementation of PCA standards meant that banks that maintained capital ratios below certain thresholds faced increased regulatory intervention despite the fact that their capital ratios exceeded regulatory minimums. Although PCA does not directly apply to BHCs, it is relevant, because it applies to their bank subsidiaries. To be considered well-capitalized under the requirements of PCA, a bank must have a ratio of tier 1 capital to risk-weighted assets of at least 6 percent, a ratio of total capital to risk-weighted assets of at least 10 percent, and tier 1 capital to average tangible assets of at least 5 percent.

In the late 1980s, prior to Basel I rules, the Federal Reserve Board had established that 7 percent was an important level for the total capital ratio. BHCs with total capital that exceeded 7 percent of assets were considered adequately capitalized and faced less intense monitoring and a lower likelihood of supervisory actions than BHCs with ratios below 7 percent, but above 6 percent, the required minimum.

Another reason that BHCs may want to hold capital above Basel I or even the PCA regulatory limits is for protection against downturns in the business cycle and unanticipated events. Additional capital may also be desirable because it would provide BHCs with flexibility that could be used to pursue potentially profitable opportunities such as acquisitions or other types of expansion. Moreover, a buffer may be desirable so that losses do not restrict the BHC's ability to engage in certain businesses. Of course,

still another reason that BHCs may maintain capital ratios that exceed regulatory minimums is that the level of capital dictated by the market may exceed the level that would be held because of regulatory requirements.

To make the relationship between excess regulatory capital and merger activity more explicit, measures of BHC capitalization are expressed in terms of excess regulatory capital, which is calculated as actual capital ratios less some critical level based on regulatory requirements or standards. The critical levels chosen for this purpose will be those that must be exceeded to be considered strongly capitalized. More specifically, we use the three ratios required for a bank to be considered-well capitalized under PCA (tier 1 capital to risk-weighted assets of 6 percent, total capital to risk-weighted assets of 10 percent, and tier 1 capital to average tangible assets of 5 percent) for analysis of the years since 1990 and the total capital ratio level (7 percent of assets) required to avoid additional scrutiny in the late 1980s. Although no level for a strong level of the primary capital ratio was defined by the regulator prior to 1991, we use 6.5 percent (the regulatory minimum of 5.5 percent plus 1 percentage point) as an estimate for a primary capital ratio that would be considered a sign of a strong BHC. Table 1 presents a summary of the various capital ratios, requirements, and variables that are relevant for different time periods.

For each BHC, we construct a variable that measures the overall constraint faced by the BHC by taking the minimum of all the measures of excess regulatory capital that were relevant during the year. Because BHCs must satisfy all the capital requirements in effect at a given time, the ratio that reflects the weakest, or most binding, actual capital

position is the one that is likely to be most relevant for the BHC. We recognize that simply taking the lowest value is imprecise. For example, ratios are based on different numerators, and, in recent years, different denominators. Nonetheless, we believe that the magnitude of the smallest excess capital measure provides a reasonable proxy for the extent of capital constraints faced by a BHC. For test 1, we measure excess capital at the beginning of each year under investigation (1993-2002 or 1998-2002), and for test 2, we measure it at the beginning of 1987 for the pre-PCA period and at the beginning of 1991 for the post-PCA period.

In short, we take the smallest difference between each of the capital ratios from among the relevant set of regulatory ratios and the value required to be considered strongly capitalized. While not adjusted for individual levels of BHC risk and risk tolerance or for idiosyncratic needs to meet capital requirements, we nonetheless believe that our measure of excess regulatory capital roughly captures the degree to which a BHC faced regulatory capital constraints.

V. Results

Before considering the results of our two tests, we note first another finding that is relevant to the question of the Basel II proposal and merger activity. Examination of previous mergers indicates that banking organizations that were acquired by the large BHCs in our sample tended to have *larger* capital ratios than their acquirers. This finding is relevant to concerns about A-IRB, because if BHCs desire to acquire banking

organizations with greater capitalization, then a bifurcated system of regulatory capital may encourage them to increase the extent to which they acquire other banking organizations.

The observed difference in the capitalization of large acquirers and their targets, however, may simply result from the fact that large banking organizations tend to have lower capital ratios than smaller ones, perhaps because market determined capital requirements tend to be greater for smaller organizations than for larger ones, and because larger organizations disproportionately acquire smaller ones. Moreover, as discussed earlier, prior studies have consistently found that banks with lower levels of capital are more likely to be acquired than better capitalized banks, suggesting that the desire to obtain a large amount of capital is not a strong motive in many bank acquisitions. In any event, the two tests that we conduct provide a more thorough and rigorous examination of the question of whether changes in regulatory capital requirements might be expected to influence merger activity.

Test 1. In the first type of test conducted, we estimate, for two different samples of BHCs and for two different time periods, the relationship between a BHC's merger activity and its excess capital, defined as the minimum of the difference between each of three actual capital ratio measures and that level of those ratios required to be considered strongly capitalized. Table 2 provides definitions of the independent variables used in these estimations.

Because many of the BHCs in the sample made no acquisitions during at least

some of the years in which they are observed, each of the two dependent variables used to measure annual merger activity (the number of acquisitions and the ratio of banking assets acquired to the assets of the acquirer) receive the value of zero for many observations. Because of the well-known violation of OLS assumptions that this entails, other estimation procedures must be used. Since the number of annual acquisitions made by a BHC is a count of the number of occurrences of an event, we use negative binomial maximum-likelihood regression when this variable is employed to measure merger activity.[12] Since the ratio of acquired banking assets to the assets of the acquirer may be thought of as a continuous variable that is censored at zero, we use Tobit maximum-likelihood regressions when this variable is employed to measure merger activity.

Each reported regression includes as an explanatory variable the BHC's expense ratio (*expense ratio*), calculated for the previous year as total noninterest expenses divided by the sum of total noninterest income and net interest income. This rough, but widely used, measure of a BHC's efficiency is included as an explanatory variable because it is often asserted that greater efficiency is associated with greater acquisition activity, as more efficient firms frequently acquire less efficient ones.[13] A negative and significant coefficient on this variable would be consistent with this hypothesis, because more

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[12]Because assumptions underlying the more common Poisson maximum-likelihood regressions could be rejected, this more general estimation procedure was chosen. See chapter 19 of Wooldridge (2002) for an extensive discussion on these regression models.

[13]Akhavein, Berger, and Humphrey (1997) and Vander Vennet (1996) report evidence consistent with this.

efficient firms have lower values of this expense ratio.

To account for differences in the economic conditions in which BHCs in the sample operate, we employ the annual change in housing prices, collected from a weighted repeat sales index (the House Price Index) produced by the Office of Federal Housing Enterprise Oversight. Price changes are measured at the state level and over the same year as merger activity. For BHCs with banking assets in more than one state, a weighted average of these state-specific measures is used, with each state's share of the BHC's total deposits used as the weights.[14]

For each type of estimation, results using two different functional forms are presented, conforming to specifications (1) and (2) above. The first employs as an explanatory variable *excregcap*, which is a continuous measure of excess regulatory capital, measured, as described above, as the minimum difference between each of the three observed capital ratios and that level of each ratio required to be considered well capitalized under PCA. The second replaces this variable with two binary variables indicating different ranges of *excregcap* observed for the BHC. The variable *excregcap(1-2)* indicates that the BHC's excess regulatory capital, measured as described above, is between 1 percentage point and 2 percentage points, while *excregcap(>2)* is similarly defined for BHCs that have excess regulatory capital of at least 2 percentage

[14]We also account for local economic conditions by including a variable that measures the average unemployment rate in the state or states in which a BHC operates. Results (not reported) using this variable are the same as those obtained using the annual change in housing prices.

points. BHC and year combinations in which the minimum capital differential is less than 1 percentage point represent the omitted category.

Tables 3 and 4 report regression results obtained for the 1998-2002 period, and tables 5 and 6 report the results of equivalent estimations conducted for the longer 1993-2002 period. All reported regressions include year fixed effects (reported only in tables 3 and 4 for reasons of space) and BHC fixed effects (not reported in any tables for reasons of space). Tables 3 through 6 each presents four different estimations, organized into two pairs. The first pair reports the results of negative binomial maximum-likelihood regressions when the number of acquisitions serves as the dependent variable, while the second pair present the results of Tobit maximum-likelihood regressions when the ratio of acquired banking assets to assets of the acquirer serves as the dependent variable.

Consider first table 3, which presents results obtained for the period 1998-2002 for a sample consisting of the ten mandatory A-IRB BHCs and the nine other BHCs with total assets of at least $50 billion as of mid-year 2003. This sample may be the most immediately relevant to the Basel II proposal, since it is composed specifically of those BHCs whose regulatory capital requirements would be the most likely to be directly affected by the proposal. Of the nineteen BHCs in this group, four are excluded from these estimations because they made no acquisitions during the period.[15]

[15]These observations are dropped, because the fixed-effects statistical model that is used in the empirical analysis requires that, for a given BHC, acquisition activity exhibit some variation over time.

The finding of positive and statistically significant coefficients on the measures of excess regulatory capital would be consistent with the hypothesis that greater excess regulatory capital enabled or induced BHCs to increase acquisition activity. However, the coefficients reported in 3 are not statistically significant. Indeed the coefficients on *excregcap*, the continuous measure of excess regulatory capital, are negative and insignificant. The coefficients on the binary variable *excregcap(1-2)* are positive when either the number of mergers or the ratio of assets acquired to total assets is used to measure merger activity, and the coefficient on *excregcap(>2)* is positive when the ratios of assets acquired to total assets is used, but these coefficients are also not statistically significant, both individually and jointly, with either measure of merger activity.

The coefficients on *expratio* are negative, consistent with the hypothesis that less efficient BHCs (i.e., those with higher expense ratios) are less likely to acquire other banking organizations, but they are not statistically significant. The coefficients on *hpchange*, the change in housing prices during the year, are positive, as might be expected if a better state economy is associated with a greater tendency for BHCs to acquire other banking institutions, but they are also not statistically significant. The coefficients on the year binary variables are negative and, in most cases, statistically significant, reflecting the fact that 1998, the year representing the omitted category, saw a greater amount of merger activity than later years in the period.

Our inability to find a statistically significant relationship between merger activity and excess regulatory capital may reflect the possibility that the level of capitalization

required by the market is, for the most part, greater than that required by regulation, with no relationship between regulatory requirements and merger activity the result. However, this lack of statistical significance may also reflect the small size of the sample, chosen to contain only those BHCs that are the most likely to be required to adopt or the most likely to adopt voluntarily the A-IRB approach.

Table 4 reports the results of the same regressions, run on a larger sample obtained by lowering the size threshold from $50 billion to $15 billion in total consolidated assets as of mid-year 2003. The result is an increase in the number of BHCs in the analysis from 15 to 33 and an increase in the number of year-BHC observations from 75 to 165. For this larger sample, the coefficients on all measures of excess regulatory capital are positive, consistent with the hypothesis that excess regulatory capital induces or enables BHCs to engage in more acquisition activity, but again, none are statistically significant. The estimated coefficients on *excregcap(1-2)* and *excregcap(>2)* are jointly insignificant as well.

The coefficients on *expense ratio* are negative, consistent with the hypothesis that less efficient banking organizations exhibit less of a tendency to acquire other organizations, and these coefficients are highly significant when the ratio of assets acquired to total assets is used as the measure of merger activity. The coefficients on *hpchange* are not statistically significant, while the coefficients of the year binary variables are all negative and, in most cases, highly significant, reflecting the general decline in merger activity occurring after 1998.

Tables 5 and 6 report estimates for regressions equivalent to those reported in tables 3 and 4, except that they employ panel data sets that extend from 1993 to 2002 instead of from 1998 to 2002.[16] Table 5 reports these results for a sample consisting only of BHCs with greater than $50 billion in consolidated assets (which includes all mandatory A-IRB BHCs). Again, all coefficients on variables that measure the degree of excess regulatory capital are positive, but not statistically significant. The coefficients on the two binary excess capital variables are also jointly insignificant.

The coefficients on *expratio* are all negative and, for this sample, highly significant in every case, consistent with the hypothesis that more efficient banking organizations exhibit a greater tendency to acquire other banking organizations. The coefficients on *hpchange* are not statistically significant. Year fixed effects in the case of this longer panel are not shown for reasons of space.

Table 6 reports the results of equivalent regressions when the sample is expanded to include BHCs with greater than $15 billion in consolidated assets as of mid-year 2003. Because of the many years and BHCs included as observations, this sample is the largest of those for which results are reported, and here, we do find statistically significant positive coefficients on the measures of excess regulatory capital when the number of mergers is the measure of merger activity, but not when the ratio of acquired assets to total

[16]Note that the samples analyzed over the 1993-2002 period contain more BHCs than the samples analyzed over the shorter 1998-2002 period, because, for this longer panel, fewer BHCs were omitted as a result of making no acquisitions during the period. Only two BHCs made no acquisitions between 1993 and 2002.

assets is used as the measure. In this latter case, the coefficients on the binary capital variables are not jointly significant either. Also in the case of this sample, the coefficients on *expense ratio* are negative and statistically significant in most cases, while the coefficients on *hpchange* are not significant.

As previously noted, one possible route by which excess regulatory capital could affect merger activity is by first influencing return on equity and firm valuation. We examine this route empirically by including lagged return on equity both as an additional variable in the regression equation (with lagged measures of excess regulatory capital) and as a replacement for measures of excess regulatory capital. In both cases, results (not reported) indicate a positive relationship between return on equity and subsequent acquisition activity, as measured by the number of deals, when estimated over the ten-year period. However, results are not significant when regressions are estimated over the five-year period and are mixed when estimated over the ten-year period with merger activity measured by the ratio of acquired assets to acquirer assets. Thus, results are only weakly consistent with the argument that regulatory capital standards influence merger activity by affecting return on equity and bank valuation. Importantly, the results are also consistent with various alternative explanations of the relationships between excess regulatory capital, return on equity, and merger activity.[17]

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[17]The interpretation of results is complicated by including return on equity as an additional explanatory variable. The reason is that, with inclusion of a measure of return on equity in the regression, the coefficient of excess regulatory capital would capture only the effect of excess regulatory capital on merger activity that would exist with return on

Summarizing the results reported in tables 3 through 6, we find that coefficients on measures of excess regulatory capital are generally positive, consistent with the hypothesis that excess regulatory capital induces or enables BHCs to increase their level of merger activity, but in most cases are statistically insignificant. Indeed, such coefficients are statistically significant only when the largest sample is employed, and then only for the case in which merger activity is measured by the number of annual acquisitions.

Despite these generally weak regression results, it is still possible that the relationship between excess regulatory capital and BHC merger activity is quantitatively important, based on the magnitude of estimated coefficients. To address this issue, we estimate the likely range of the quantitative impact of adoption of the A-IRB approach on merger activity by combining coefficient estimates with estimates of changes in excess regulatory capital that might result from adoption of A-IRB.

The Third Quantitative Impact Study (QIS 3) was conducted by the Basel Committee on Banking Supervision to understand the possible effects that the Basel II proposals (as of late 2002) might have on capital levels across participating banks.[18]

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equity held constant. Thus, for example, the inclusion of return on equity as an additional explanatory variable would leave no observable effect of excess regulatory capital on merger activity if excess regulatory capital only affects merger activity through its influence on the return on equity. It should also be noted that in any model that includes return on equity, the empirical relationship between return on equity and merger activity would reflect all aspects of the underlying relationship between the two measures, not just those related to the effect of excess capital on return on equity.

[18]The evolution of the Basel proposal, of course, implies that the QIS 3 may not be a good indicator of the effect of the present proposal. Another quantitative impact study is

Based on data for 22 U.S. BHCs, the QIS 3 estimated that adoption of A-IRB would, by reducing certain risk weights, lead to an average reduction in total risk-weighted assets (RWA) of 6 percent. This change would have the effect of raising the ratios of tier 1 to RWA and total capital to RWA. A change in RWA has no effect on the leverage ratio (total capital to average tangible assets), because the denominator is not based on RWA.

We calculate the three relevant regulatory capital ratios–tier 1 capital to RWA, total capital to RWA, and tier 1 capital to average tangible assets–for each of the 38 BHCs in the sample using data from June 30, 2003. We also estimate the value of those ratios under the A-IRB approach by assuming that RWA would be 6 percent lower than the level reported as of that date. Then, for both sets of the three ratios, we compute the difference between each of the ratios and the minimum needed to be considered well capitalized under PCA standards (see table 1). Next, for both the standard and A-IRB approach, we take the minimum of the three differences. Finally, we subtract the excess capital figure computed under current capital rules from the excess capital figure obtained under the A-IRB approach to get an estimate of the change in excess regulatory capital (expressed as a ratio) that a BHC would experience with the adoption of the A-IRB approach. It should be noted that this final figure will be 0 if the BHC were constrained by the leverage ratio under both capital approaches, since the leverage ratio would be unaffected by adoption of A-IRB.

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planned for later in 2004.

On average, we find (using QIS 3 results) that adoption of A-IRB would result in an increase in a BHC's excess regulatory capital (expressed as a ratio) of 0.31 percentage points. However, it should be noted that this estimate assumes that every BHC in the sample experienced an identical change in risk-weighted assets equal to the average. In actuality, however, the change in risk-weighted assets following adoption of A-IRB should vary across BHCs. Although not accounting for this variation should affect our estimates of the change in excess regulatory capital, the results of the exercise should not be substantially influenced, because we are estimating the likely range of changes in merger activity, which is rather general.

In order to assess the economic meaning of an increase in excess regulatory capital of 0.31 percentage points, we employ the regression coefficient on *excregcap*, as well as previous levels of BHC merger activity.[19] Calculations of the range of likely changes in acquisition activity are based on the smallest and largest estimated coefficients on *excregcap*, because they generate the most extreme changes in merger activity that can be predicted from regression results.

The largest coefficient estimated for the number of deals is 0.19 (table 4), and it implies that the average number of mergers conducted by a BHC would increase by 6.1

[19]We do not examine the change in merger activity implied by coefficients on *excregcap(1-2)* and *excregcap(>2)* because we estimate that the values of these binary variables following adoption of A-IRB would change for very few BHCs in our sample.

percent, given an increase in excess regulatory capital of 0.31 percentage points.[20] The smallest coefficient estimate is -0.087 (table 3) and it corresponds to a decrease in the number of acquisitions of 2.7 percent. These percent increases translate into very modest projected changes in merger activity. The average BHC in the full sample of 38 banks conducted 1.74 deals per year between 1993 and 2002, which is greater than the 1998-2002 average for the full sample or any of the averages for the smaller sample of very large BHCs. Given this average number of deals, a 6.1 percent increase would mean an increase in the average annual number of mergers of only 0.1 acquisitions per large BHC, and a 2.7 percent decrease would mean 0.05 fewer acquisitions per year for each large BHC.

With respect to the ratio of acquired banking assets to total BHC assets, the largest coefficient is 0.049 (table 4) and the smallest one is -0.022 (table 3). Respectively, these estimates imply changes in the average value of acquired assets to acquirer assets of 1.5 percentage points and -0.7 percentage points following a 0.31 percentage point jump in excess regulatory capital.[21]

Several caveats suggest that these estimated changes in BHC merger activity that would follow adoption of the A-IRB approach should be viewed as rough, back-of-the-

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[20]For the negative binomial regression, the percentage increase in the number of mergers for a given change in excess capital (Δexcregcap) can be computed as ($100 \times e^{(\beta)(\Delta \text{excregcap})} - 100$), which in this case equals $100 \times e^{(0.19)(0.31)} - 100$.

[21]The percentage point increase in the ratio of acquired assets to acquirer assets for a given change in excess capital (Δexcregcap) can be computed simply as $100 \times \beta \times \Delta$excregcap.

envelope calculations. First, the analysis is static and does not take into account the effect of portfolio changes that could accompany adoption. If BHCs increase the relative share of their assets held in categories that would receive lower risk weights, then the increase in excess regulatory capital could be greater than the estimate of 0.31 percentage points. Second, the data used to estimate changes in RWA are based on QIS 3, which analyzed the effect of the Basel II proposal that was current at the time of the study (late 2002/early 2003). The regulatory capital rules that are ultimately adopted are likely to differ from those used in QIS 3. Finally, we have noted that the estimated change in excess regulatory capital incorporated in this analysis is based on the average change in risk-weighted assets and does not take into account the wide range of possible changes that individual BHCs may experience.

In summary, our estimates suggest that the likely change in the number of acquisitions that would follow adoption of the A-IRB capital approach would fall within a narrow range, and that the number of acquisitions would be unlikely to change much following adoption. This result is especially notable because the only significant results obtained in test 1 are for the case in which acquisition activity is measured by the number of deals. Estimates of the change in the ratio of acquired assets to BHC assets includes more extreme values and the likely range is therefore larger. However, all of these estimates are based on statistically insignificant coefficients.

Test 2. Tables 7 and 8 present the results of t-tests that analyze the effect on merger activity of generally tighter capital requirements brought about by the adoption of

PCA capital standards. In these two tables, merger activity before PCA is measured as the average number of mergers per year during the period 1987-1989. Merger activity after the time that the requirements of PCA should have been foreseen, assumed to be the beginning of 1991, is measured as the average number of mergers per year for the period 1991-1992.[22]

Only BHCs judged to be relatively unconstrained by the capital requirements in effect prior to the advent of PCA (the "old standards") are included in the comparisons. Such BHCs are defined as those that met the requirement for being "strongly capitalized" (primary capital ratio of at least 6.5 percent and total capital ratio of at least 7 percent) as of December 31, 1986, the start of our pre-PCA period. In addition, we require that the primary capital and total capital ratios of sample BHCs as of December 31, 1990, the start of our post-PCA period, also exceed 6.5 percent and 7 percent, respectively. Requiring sample BHCs to be well-capitalized under the "old standards" at the start of both periods increases the likelihood that the change in acquisition activity undertaken by a BHC over the analysis period is affected largely by the new PCA standards, and is not heavily influenced by any underlying weakness in the BHC's capital position that would have

[22]Although PCA was enacted in December 1991 and fully implemented at the end of 1992, we believe that 1991-92, which took place before PCA became legally binding, is the appropriate period to use as the time that PCA standards first became relevant. The data show that in 1991 sample BHCs with less excess regulatory capital, as measured with the ratios relevant under PCA, increased their excess regulatory capital by more than sample BHCs with greater excess regulatory capital measured with those ratios. This behavior suggests that the standards that would become legally effective at the end of 1992 were already affecting BHCs in 1991. Nonetheless, the results of the analysis are similar if 1992-93 is used as the post-PCA period.

affected merger activity even if standards had not been increased.

BHCs are split into two groups–those that became constrained by the "new standards" introduced by PCA and those that remained unconstrained under these standards. In the post-PCA period, a BHC is classified as constrained if it fails to meet any of the requirements for being well capitalized under PCA (see table 1) as of December 31, 1990. BHCs that meet all three of these requirements are counted as unconstrained after the change to the new capital regime. Clearly, other definitions of what constitutes a binding capital constraint are possible, and we discuss below the results of tests that employ alternative definitions.

Table 7 reports the results of this test for the sample of sixteen mandatory A-IRB BHCs and other BHCs with consolidated assets greater than $50 billion (as of mid-year 2003) that met the definition of being unconstrained under the "old standards" as of year-end 1986 and year-end 1990. The first row indicates that for those BHCs that became constrained by PCA capital standards (nine BHCs), mergers per year declined from an average of 1.63 during the period 1987-1989 to .61 during the 1991-1992 period. The second row indicates that for the group of BHCs judged not to have become constrained by PCA standards (seven BHCs), mergers actually increased slightly, from 1.33 per year during the 1987-1989 period to 1.50 per year in the period 1991-1992. Perhaps the most relevant number reported in table 7 is the "difference in difference" reported in the third column of the third row. This figure shows that BHCs that became constrained participated in 1.19 fewer mergers per year, on average, than would have been the case

had they not become constrained, assuming their merger activity changed after the introduction of PCA in the same way as the group that remained unconstrained. Although the difference between the two groups of BHCs is clearly consistent with the hypothesis that the imposition of binding capital requirements would cause merger activity to decline, the t-statistic calculated for this difference, and reported in the third column of the fourth row, is only -1.46, indicating that this difference is not statistically significant at levels traditionally employed to reject null hypotheses (in this case that there is no difference between the two groups).

Table 8 reports the results of an equivalent test conducted using a larger sample obtained by including those BHCs that had at least $15 billion in consolidated assets as of mid-year 2003. In this sample, those BHCs that became constrained by the requirements of PCA (eleven BHCs) reduced the number of acquisitions that they made annually from 1.48 in the period 1987-1989 to .54 in the 1991-1992 period. The seventeen BHCs in the sample that did not become constrained by the requirements of the new capital standard also exhibited a reduction in average annual acquisitions, from 1.08 in the earlier period to .76 in the later period. The "difference in difference" of -.63 indicates that BHCs that became constrained by PCA participated, on average, in .63 fewer mergers per year than would have been the case had they exhibited the same change as did those BHCs that did not become constrained. The t-statistic of -1.18 registered for this difference indicates that for this sample as well, this difference is not statistically significant.

The results obtained in test 2 appear to be robust, as we conducted a number of

alternative analyses and obtained consistent findings. The results of these additional analyses are discussed, but not reported. Results obtained using higher standards to differentiate whether a BHC is classified as capital constrained or not under the new PCA standards indicate no significant differences in the change in merger activity of the two groups of BHCs. In one of these alternative tests, we classified a BHC as constrained if any of its relevant capital ratios were less than the PCA standard plus 0.5 percentage points, and in another alternative, we used the PCA standard plus 1 percentage point to distinguish between constrained and unconstrained BHCs. Results were similar to those reported in tables 7 and 8, which present results based on PCA standards (with no additional cushion) as the level used to classify BHCs.

We also conducted analyses on an expanded sample of 54 BHCs that operated between December 31, 1986 and December 31, 1993 and that held assets of at least $5 billion as of December 31, 1986. Of these organizations, 45 were unconstrained under the "old standards." Results based on this group also fail to reject the hypothesis of no difference in the change in acquisition activity between those BHCs that became constrained by PCA standards and those that did not. Further, regression analyses that control for other variables that might influence the observed change in a BHC's merger activity, as derived in (5) above, were conducted and found to yield similar, statistically insignificant results. Finally, as noted (see footnote 22), results are similar when the post-PCA period is defined as 1992 and 1993, although more BHCs are unconstrained by PCA standards in this later period.

VI. Summary and Conclusion

This paper examines empirically the question of whether the advanced internal ratings-based (A-IRB) approach employed by certain large banking organizations to determine their regulatory capital requirements, as provided for in the Basel II proposal, would be likely to lead those banking organizations to increase their acquisition activity.

Concerns that acquisition activity would increase following adoption of A-IRB in the United States by a small number of large banking organizations stem from two consequences of using the new approach. Arguments based on these consequences can be usefully designated as "excess regulatory capital" and "relative capital advantage" arguments. "Excess regulatory capital" arguments focus on the additional excess regulatory capital that would result from a reduction in an A-IRB adopter's capital requirements as the driver of greater acquisition activity. Arguments based on the "relative capital advantage" cite the disparity in capital requirements that would exist between BHCs using the A-IRB approach and those that would not as the force fueling merger activity.

Because we cannot examine the effects of past reductions in capital requirements that affect some organizations but not others, we conduct two less definitive, but nonetheless informative, tests. The first uses recent data to determine whether large banking organizations with greater excess regulatory capital exhibited a greater tendency to subsequently acquire other banking organizations. The second examines whether the generally higher capital requirements resulting from adoption of "prompt corrective

action" standards in the early 1990s (the last time capital requirements were substantially changed) resulted in a relative reduction in merger activity on the part of those large banking organizations most severely affected by the policy.

Both of these tests are most relevant to "excess regulatory capital" arguments for increased acquisition activity. Of relevance to "relative capital advantage" arguments, however, we note that a substantial number of studies do not support a major implication of the arguments.

On the whole, we do not find convincing evidence either that past changes in excess regulatory capital or that past changes in capital standards had substantial effects on merger activity. Estimated coefficients and observed differences have signs consistent with the concern that a reduction in regulatory capital requirements for large banking organizations would result in increased merger activity on their part. However, results of the two tests are, with a few exceptions, statistically insignificant, and, in cases where results are statistically significant, quantitative magnitudes are small.

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Table 1

Capital Measures

	Relevant years	Regulatory minimum	Minimum for "strongly" capitalized	Source of definition for "strongly" capitalized
Primary capital to total assets*	1987-1989	5.5%	6.5%	Same mark-up that is used with total capital
Total capital to total assets*	1987-1989	6.0%	7.0%	Top total capital zone established in Federal Reserve System regulations
Tier 1 capital to risk-weighted assets	1990-2002	4.0%	6.0%	Prompt corrective action standards
Total capital to risk-weighted assets	1990-2002	8.0%	10.0%	Prompt corrective action standards
Tier 1 capital to total assets	1990-2002	4.0%	5.0%	Prompt corrective action standards

*The ratios of primary capital to total assets and total capital to total assets are also computed for 1990 in order to identify bank holding companies that were affected by the advent of prompt corrective action standards, but that did not experience a substantial weakening in capitalization under the standards relevant before prompt corrective action.

Table 2

Regression Variable Definitions

Variable	**Definition**
excregcap	The "excess capital" exhibited by the BHC at the beginning of the year for which merger activity is observed. Since, for the periods examined, specified values of three different types of capital ratios had to be exceeded to be considered well capitalized, this variable measures the smallest of the differences between the observed BHC's capital ratio and that level required to be considered well capitalized under prompt corrective action.
excregcap(1-2)	A binary variable indicating that excregcap is between 1 and 2 percentage points above the regulatory minimum required to be considered well capitalized.
excregcap(>2)	A binary variable indicating that excregcap is 2 or more percentage points above the regulatory minimum to be considered well capitalized.
expense ratio	The "expense ratio" exhibited by the BHC during the year previous to the year for which merger activity is observed, defined as BHC noninterest expenses, divided by the sum of noninterest income and the difference between interest income and interest expenses.
hpchange	Weighted average of the percent change in housing prices in the states in which each BHC operates, with BHC-specific state deposit shares used to calculate the weights.

Table 3

The Relationship Between Merger Activity and "Excess Regulatory Capital" for Mandatory A-IRB BHCs and other BHCs with Assets over $50 Billion as of June 30, 2003, Panel Data Estimation for the Period 1998-2002, with Year and BHC Fixed Effects

Dependent variable	Number of Mergers	Number of Mergers	Ratio of Assets Acquired to Total Assets	Ratio of Assets Acquired to Total Assets
excregcap	-.087 (-.23)		-.022 (-.24)	
excregcap(1-2)		.31 (.80)		.10 (1.03)
excregcap(>2)		.13 (.16)		-.025 (-.13)
expense ratio	-.039 (-1.03)	-.036 (-.94)	-.018 (-1.67)	-.017 (-1.53)
hpchange	.082 (.58)	.10 (.71)	.017 (.37)	.021 (.46)
Year 1999	-.44 (-.98)	-.33 (-.69)	-.35** (-2.68)	-.35** (-2.70)
Year 2000	-.87 (-1.52)	-.75 (-1.31)	-.48** (-2.68)	-.47** (-2.79)
Year 2001	-1.05+ (-1.77)	-.92+ (-1.64)	-.33+ (-1.93)	-.33+ (-1.95)
Year 2002	-1.52* (-2.57)	-1.45* (-2.46)	-.47** (-2.75)	-.47** (-2.79)
Estimation procedure:	Neg. Binomial regression	Neg. Binomial regression	Tobit regression	Tobit regression
no. of obs.	75	75	75	75
no. of BHCs	15	15	15	15

Note: t-statistics in parentheses. . +, *, and ** indicate significance at the 10, 5, and 1 percent levels, respectively. Four of nineteen BHCs are omitted from the analysis because they made no acquisitions during the time period.

Table 4

The Relationship Between Merger Activity and "Excess Regulatory Capital" for Mandatory A-IRB BHCs and other BHCs with Assets over $15 Billion as of June 30, 2003, Panel Data Estimation for the Period 1998-2002, with Year and BHC Fixed Effects

Dependent variable	Number of Mergers	Number of Mergers	Ratio of Assets Acquired to Total Assets	Ratio of Assets Acquired to Total Assets
excregcap	.19 (.99)		.049 (1.09)	
excregcap(1-2)		.31 (1.17)		.069 (.95)
excregcap(>2)		.42 (1.03)		.095 (.89)
expense ratio	-.026 (-1.13)	-.031 (-1.32)	-.016** (-2.68)	-.017** (-2.75)
hpchange	.089 (1.04)	.10 (1.20)	-.034 (-1.26)	-.033 (-1.23)
Year 1999	-.65* (-2.46)	-.62* (-2.28)	-.18* (-2.31)	-.18* (-2.30)
Year 2000	-1.06** (-2.95)	-1.12** (-3.26)	-.16 (-1.52)	-.17 (-1.61)
Year 2001	-1.20** (-3.06)	-1.25** (-3.36)	-.15 (-1.37)	-.17 (-1.52)
Year 2002	-1.63** (-4.46)	-1.66** (-4.69)	-.31** (-3.10)	-.32** (-3.22)
Estimation procedure:	Neg. Binomial regression	Neg. Binomial regression	Tobit regression	Tobit regression
no. of obs.	165	165	165	165
no. of BHCs	33	33	33	33

Note: t-statistics in parentheses. . +, *, and ** indicate significance at the 10, 5, and 1 percent levels, respectively. Five of thirty-eight BHCs are omitted from the analysis because they made no acquisitions during the time period.

Table 5

The Relationship Between Merger Activity and "Excess Regulatory Capital" for Mandatory A-IRB BHCs and BHCs with more than $50 Billion in Assets as of June 30, 2003, Panel Data Estimation for the Period 1993-2002, with Year and BHC Fixed Effects

Dependent variable	Number of Mergers	Number of Mergers	Ratio of Assets Acquired to Total Assets	Ratio of Assets Acquired to Total Assets
excregcap	.035 (0.24)		.021 (.54)	
excregcap (1-2)		.31 (1.46)		.095 (1.57)
excregcap (>2)		.48 (1.55)		.11 (1.34)
expense ratio	-.044* (-2.21)	-.050* (-2.51)	-.013* (-2.47)	-.013* (-2.51)
hpchange	-.067 (-1.15)	-.050 (-1.40)	-.0044 (-.33)	-.0042 (-.32)
(Year fixed effects not shown)				
Estimation procedure:	Neg. Binomial Regression	Neg. Binomial Regression	Tobit Regression	Tobit Regression
No. of obs.	170	170	170	170
No. of BHCs	17	17	17	17

Note: t-statistics in parentheses. . +, *, and ** indicate significance at the 10, 5, and 1 percent levels, respectively. Two of nineteen BHCs are omitted from the analysis because they made no acquisitions during the time period.

Table 6

The Relationship Between Merger Activity and "Excess Regulatory Capital" for Mandatory A-IRB BHCs and BHCs with more than $15 Billion in Assets as of June 30, 2003, Panel Data Estimation for the Period 1993-2002, with Year and BHC Fixed Effects

Dependent variable	Number of Mergers	Number of Mergers	Ratio of Assets Acquired to Total Assets	Ratio of Assets Acquired to Total Assets
excregcap	.14+ (1.91)		.033 (1.43)	
excregcap (1-2)		.42* (2.32)		.065 (1.38)
excregcap (>2)		.57* (2.49)		.082 (1.39)
expense ratio	-.018 (-1.52)	-.021+ (-1.79)	-.0077* (-2.51)	-.0080* (-2.62)
hpchange	-.031 (-.98)	-.031 (-.98)	-.01 (-1.30)	-.01 (-1.25)
(Year fixed effects not shown)				
Estimation procedure:	Neg. Binomial Regression	Neg. Binomial Regression	Tobit Regression	Tobit Regression
No. of obs.	360	360	360	360
No. of BHCs	36	36	36	36

Note: t-statistics in parentheses. . +, *, and ** indicate significance at the 10, 5, and 1 percent levels, respectively. Two of thirty-eight BHCs are omitted from the analysis because they made no acquisitions during the time period.

Table 7

Yearly Averages of the Number of Mergers Before and After "Prompt Corrective Action" and the Change from Before to After "Prompt Corrective Action" for Mandatory A-IRB BHCs and other BHCs with greater than $50 Billion in Assets as of June 30, 2003

	(1)	(2)	(3)
	Average number of mergers per year, 1987-1989	Average number of mergers per year, 1991-1992	Change between the two periods
(a) BHCs not constrained before but constrained after "prompt corrective action" (9 obs)	1.63	.61	-1.02
(b) BHCs not constrained in either period (7 obs)	1.33	1.50	.17
(c) Difference between the groups, (a) - (b)	.30	-.89	-1.19
(d) t-statistic for the difference in (c)[1]	.54	-1.35	-1.46

[1]assumes unequal variance. Differences may reflect rounding error.

Table 8

Yearly Averages of the Number of Mergers Before and After "Prompt Corrective Action" and the Change from Before to After "Prompt Corrective Action" for Mandatory A-IRB BHCs and other BHCs with greater than $15 Billion in Assets as of June 30, 2003

	(1) Average number of mergers per year, 1987-1989	(2) Average number of mergers per year, 1991-1992	(3) Change between the two periods
(a) BHCs not constrained before but constrained after "prompt corrective action" (11 obs)	1.48	.54	-.94
(b) BHCs not constrained in either period (17 obs)	1.08	.76	-.31
(c) Difference between the groups, (a) - (b)	.41	-.22	-.63
(d) t-statistic for the difference in (c)[1]	.91	- .64	-1.18

[1]assumes unequal variance. Differences may reflect rounding error.

A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate

Testimony by Institutional Risk Analytics

Committee on Financial Services

U.S. House of Representatives

September 14, 2006

www.institutionalriskanalytics.com

Mr. Chairman and Members of the Committee:

As requested by the Committee, we submit this written testimony regarding the issues surrounding the New Basel Capital Accord or Basel II. We will be pleased to answer any questions you may have regarding this testimony.

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When we think about Basel II, the first issue that comes to mind is the question of national interest. Before all other considerations, we believe that it is important to put the Basel II framework, as well as related regulatory initiatives, into the proper context and to recognize that successful implementation is good for the United States, for consumers as well as providers of financial services. Related regulatory initiatives include the revisions to the collection of counterparty risk data for the Shared National Credits survey ("SNC"), the revised rule on Complex Structured Financial Instruments, and the public and private sector efforts to improve Counterparty Risk Management practices in the US and globally.

Second is the issue of improving and aligning global credit risk practices. More than merely measuring the capital adequacy of a financial institution, the Basel II framework and related regulatory initiatives are about creating a common set of terms and data that describe the financial risks which banks originate and trade with other market participants. Credit risk terms such as Probability of Default, Loss Given Default, Exposure at Default and Maturity are being refined into the new benchmarks for bank safety and soundness – separate and apart from whether one uses such metrics to measure a bank's capital adequacy.

While the political delay of the Basel II process in the US has slowed the adoption of such credit risk measures for gauging whether a bank has sufficient capital to support its various lines of business, in fact the credit metrics described by these relationships are becoming the industry standard for managing risk – albeit with many different labels and definitions. The Basel II process offers the financial community the opportunity to refine and codify these types of measures of risk into a consistent and transparent dictionary of terms for describing the business models of banks.

The third issue which occurs to us when we look at the Basel II process is, we regret to say, a failure of vision. Despite the obvious national and technical benefits promised by Basel II, we believe that both the regulators and the banking industry have failed the nation and themselves by allowing the process to degenerate into a narrow debate over partisan political interests rather than a cooperative effort to align global bank credit and capital measures.

True, a great deal of the blame can be put at the feet of the Federal Reserve Board, Office of the Comptroller of the Currency and other agencies for not better defining the Basel II proposal, in specific technical terms, and also for not leading the development effort with greater purpose; that is, by example. The years spent on this process and the mixed results yielded to date do not inspire great confidence in the ability of the various regulatory agencies to lead the Basel II process to a successful conclusion and implementation.

But it would be equally wrong not to place at least equal blame with the banking industry for the failure to adopt Basel II in the US. The largest money center banks are the moved movers of Basel II. They demanded a more sensitive and sensible approach to measuring the way that internationally active banks take and mitigate risk. In particular, the largest institutions rightly sought an end to the static measures of capital adequacy currently used to compute risk based capital, measures which virtually all risk professionals agree do not truly measure the risks taken by banks today.

Instead of leading the process by example and working to create a transparent and consistent framework for measuring the capital adequacy of all US banks, the largest banks and their political supporters instead have acted out of self interest. Rather than considering the overwhelming national interest argument for moving forward with Basel II, a woeful state now exists where each bank is arguing for unique treatment under the Basel II rules, this rather than supporting a common set of measures to benchmark capital adequacy for all US banks.

In 2005, after the Congress raised objections with regulators regarding the composition of the Basel II proposal, particularly with respect to the general consensus that bank capital levels would fall under Basel II,[1] the regulators took a step back from the more ambitious goals of Basel II. The static gearing ratio for measuring capital to assets already used by regulators under the Basel I framework was explicitly retained in the proposal and other changes were made to in essence maintain the current methods of measuring whether a bank has sufficient capital to support the risks that it takes in the marketplace.

Our sources in the industry tell us that the changes made to the Basel II proposal since last year, changes which are reflected in the draft proposal published last week by the Federal Reserve Board and other agencies, have largely taken away the attractiveness of pursuing the more advanced levels of the Basel II framework. Indeed, it is no surprise that four of the largest banks have written to the Federal Reserve Board asking to be allowed to opt-out of the most rigorous and technically challenging aspects of the Basel II proposal, in favor of what is known as the standardized approach.

We view this development with alarm and we suggest to the Committee that the reluctance of some of the most sophisticated and well-run financial institutions in the US to pursue the full menu of risk management enhancements proposed under the current Basel II framework means that the regulators need to go back to the drawing board. Our suggestion to the Committee is that the regulators should observe three basic principals of risk management and financial analytics when approaching the task of finalizing the Basel II framework:

- Standardization of risk measures
- Transparency of risk disclosure
- Comparability of capital adequacy metrics

Following these core principles, we believe, will help the Congress and the regulators shape a Basel II proposal that is worthy of support by the banking industry and the Congress.

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[1] See "Summary Findings of the Fourth Quantitative Impact Study," February 2006.

First is the issue is standardization of capital adequacy measures. We reject the core assumption of Basel II that each bank deserves "special treatment" when it comes to assessing its risk based capital needs. Accepting the view currently held by the Federal Reserve Board means that calculating a bank's capital needs and assessing its operational safety and soundness will be an entirely subjective process. To make Basel II work, the Fed and other US regulators need to come up with a simplified version of the framework that is easy to implement, validate and most important, explain to observers outside the industry.

Second is the related issue of transparency. The single biggest obstacle to political approval of Basel II is the accord's reliance on privileged, non-public financial data to gauge compliance. If you begin with the assumption in the current Basel II proposal that each bank deserves "special treatment" and combine the fact that most of the data used to measure capital adequacy will never be disclosed to the public of the Congress, you end up with an unworkable situation. At the very least, it will be impossible for the Congress to conduct oversight of the current Basel II proposal.

Under the current Basel II proposal, perhaps the most important single issue of bank supervision affecting any institution will be decided in private, away from public scrutiny and the oversight of the Congress. If regulators, investors and risk professionals can't examine the Basel II metrics or the data used to produce them, then there is no validation and no market discipline. And that means there is no Pillar III process, the key element of Basel II which the Bank for International Settlements identifies as critical to making the framework viable.[2]

Third is the issue of comparability, one of the most import aspects of the current Basel I capital framework. If the current Basel II proposal is adopted, then there will be no way to compare the risk profiles of different US banks. Since virtually all of the processes and data used to measure compliance with Basel II will be based upon privileged, non-public information, there will be no way for investors, regulators, other banks or the Congress to easily make observations about the risk profiles of different banks or industry sectors.

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[2] See "Using Public Data Benchmarking for Basel II," *GARP Risk Review*, May/June, 2006, Pg. 30.

Fortunately, the part of the answer to many of these issues is easily at hand, namely using existing public data and enhancements to public data disclosure to create a framework for benchmarking the risk profiles of all US banks. Specifically, the portfolio level financial statement data gathered by the Federal Deposit Insurance Corporation on behalf of the members of the Federal Financial Institutions Examinations Council, should be used by regulators to create benchmarks for the found basic measures of the Basel II proposal – measures which are shared, by no coincidence, in the proposed revisions to the SNC reporting framework.

Over the past year, we have prepared public data benchmarks for the major Basel II factors using data from the FDIC's Research Information Service. We believe that these public benchmarks provide very powerful measures for how and where banks deploy assets and take risks, measures which if combined with new counterparty risk data proposed to be gathered as part of the SNC proposal, could provide a greatly enhanced picture of the economic capital required to support a bank's business.[3]

Once regulators accept the concept of using public data for Basel II and establish transparent methods for calculating the key credit metrics such as Probability of Default, Loss Given Default, Exposure at Default and Maturity, the regulators can then benchmark the entire US banking industry, not just the largest banks. Such an approach would greatly enhance the ability of the Fed to gain industry support for the proposal and lessen political opposition in Washington.

Complexity is not clarity. Trying to gain approval of a Basel II proposal that relies on non-public data and is therefore difficult to illustrate in concrete, dollars and cents terms, strikes us and many risk managers as a tall order. It is not too late for the US regulators to change course and adopt a proposal that enhances the current Basel I framework, using public, portfolio-level data already available from the FDIC.

[3] A copy of our latest Basel II survey, "Basel II by the Numbers," for Q1 2006 is attached as Appendix A.

By taking this route, the US would continue to rely on the principles of transparency and comparability which have made the its banking industry the envy of the world for over a century and thereby save the Basel II process from what seems to be a increasingly doubtful future.

#

APPENDIX A

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Basel II by the Numbers: Q1 2006

This report presents public data Basel II credit benchmarks derived from the IRA Bank Monitor for more than 360 US bank holding companies ("BHC"). The IRA Bank Monitor provides 18 years of historical, portfolio-level performance and Basel II benchmarks for all federally insured depository institutions. This report includes BHCs which operated in the US market as of March 31, 2006.

The metrics presented in this report are based on "as filed" data from the Research Information Service ("RIS") of the Federal Deposit Insurance Corp and aggregate financial results for the subsidiary banks of the BHC, rolled-up into a "bank only" profile. The results of the Basel II and performance benchmarks in this report are grouped into four subsets based upon the BHC's asset size:

- Large Holding Companies Over $10 Billion Assets — Page 11
- Mid-Size Holding Companies $1B to $10B Assets — Page 17
- Small Holding Companies $500M to $1B Assets — Page 25
- Micro Holding Companies Under $500M Assets — Page 33

Please note that thrifts are not listed in this edition of the *Basel II by the Numbers* series. The Office of Thrift Supervision's policy controlling the FDIC research feed prevents transmission of portfolio and aggregate maturity data for thrifts in electronic form – even though the data is public. This makes it impossible to calculate a key Basel metric – weighted average maturity or WAM. We are addressing our observations to the OTS and look forward including this class of institutions in future editions of *Basel II by the Numbers*.

As with IRA's previous report, we are again using a test methodology that sets a very high hurdle in terms of capital adequacy by measuring the amount of Economic Capital ("EC") a firm needs and comparing this result with the bank's regulatory capital requirement. Under Basel II, EC is broadly considered to be the amount of capital a financial services firm's own internal risk assessment determines it should hold.[1]

[1] See Porteous & McCullough, "An approach to economic capital for financial services firms," *Risk*, April 2003. (www.risk.net).

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Basel II by the Numbers: Q1 2006

Our benchmarking efforts continue to focus on a perspective that is an apparent opposite of that selected in the Quantitative Impact Survey conducted by US regulators during 2005. Specifically, this Basel II simulation poses the key question: How much Economic Capital does a given banking organization need in order to sustain severe losses on its risk bearing trading book and yet keep its external credit ratings stable? By focusing on the stressed scenario rather than the "best case" scenario highlighted in QIS 4, we hope to shed light on the assumptions in the current debate over Basel II.

This methodology may seem arbitrary – and it is, intentionally so. The point of the simulation presented in this report is not to test compliance with the notional rules of Basel II, rules which are still not finalized at this writing, but instead to examine the safety and soundness of an institution compared with its peers using the valuable concepts upon which Basel II is meant to be based. This is, after all, what the risk management process is really about; understanding individual subject behavior, not to auto correlate a notional target point as seems to have been the result – if not the intention -- of the QIS 4 survey.

As in previous reports, we are overly generous in our assumptions regarding the treatment of risk-free exposure for assets such as GSE obligations and harshly prudish in the way we approach trading risks, but we also allow expected loan losses to be defined by recent loan default experience, an assumption we feel is quite liberal. As discussed below, current bank loan default rates in the US are so low as to be incredible and thus understate risks in the banking book.

The good news is that the US banking industry does not seem to be suffering a capital crisis, as many of the opponents of Basel II would argue. As you would expect, our Basel II scenario seemingly confirms that larger banks are riskier than mid-size, small and micro institutions. Indeed, the test results suggest that smaller banks are far better capitalized than their larger peers relative to the risks they take. These results also call into question current regulatory attention on enhancing risk management practices in smaller institutions. The attention of regulators would seem to be better allocated to the largest banks that are playing far beyond the margin in terms of the adequacy of their current capital.

The bad news is that the smaller banks especially and all US banks generally are probably more risky than their current Basel II profiles suggest. Despite the very low loan loss rates reported by US banks during Q1 2006, we continue to believe that bank loan default rates reflected in the FDIC RIS understate the economic reality by at least two full letter default rating grades. Thus an exploration of the possible EC requirements for banks during a future period of above-normal loan default rates seems both timely and of great significance to the risk community, regulators and the banking public.

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Basel II by the Numbers: Q1 2006

Finally, we have greatly expanded the universe of banks surveyed in this edition of *Basel II by the Numbers*. Where previous editions focused only on large banks, this edition adds coverage of three additional asset strata in the U.S. banking universe. As we continue to examine our benchmarking strategy, we find ourselves confirming over and over again the delightful fact that bank business models are indeed quite varied and innovative. We hope that this expanded sample allows you to appreciate this diversity and see them all in a more transparent, apples-to-apples fashion.

Dennis Santiago
Christopher Whalen
July 20, 2006

Ongoing research, technical analysis and methodology development of Basel II by the Numbers is directed by IRA CEO Dennis Santiago.

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Basel II by the Numbers: Q1 2006

Highlights

- Whereas surveys conducted by US bank regulators suggest that under the Basel II proposal some of the largest US banks would need less EC than current regulatory minimum capital levels, the "fully stressed" simulation presented in this report suggests that some of the largest US banks would require significantly more EC than current minimum levels of Tier One Risk Based Capital ("RBC"), particularly during an economic downturn.

- For example, JP Morgan Chase (NYSE:JPM) would require EC equal to 5.4x current Tier One RBC in order to maintain its credit rating during a period of extreme stress -- which is defined as the institution sustaining significant, high double-digit percentage losses to the risk bearing portion of the trading and investment books. Under this same scenario, Citigroup (NYSE:C) would require 3.4x Tier One RBC, Bank of America 1.6x Tier One RBC and Wachovia Corp (NYSE:WB) 2.1x Tier One RBC.

- Table One below shows the results for the ratio of EC to Tier One RBC for the top ten largest BHCs in the US market. The average ratio of EC to Tier One RBC for this group is 1.94, the median is 1.26 and the STDEV is 1.66.

Holding Company	EC to Tier One RBC
BANK OF AMERICA CORPORATION	1.589
JPMORGAN CHASE & CO.	5.438
CITIGROUP INC.	3.379
WACHOVIA CORPORATION	2.120
WELLS FARGO & COMPANY	0.927
U.S. BANCORP	0.694
SUNTRUST BANKS, INC.	0.765
HSBC HOLDINGS PLC	3.418
ROYAL BANK OF SCOTLAND GROUP	0.654
NATIONAL CITY CORP	0.377

Source: IRA Bank Monitor

- Notice that some of the largest banks in the US, such as US Bancorp (NYSE:USB), the subsidiaries of Royal Bank of Scotland (NYSE:RBS) and National City Corp (NYSE:NCC) were assigned a significantly lower ratio of EC to Tier One RBC in this simulation than some of their peers, perhaps suggesting that these franchises are pursuing different business model goals than the large bank group as a whole.

Basel II by the Numbers: Q1 2006

- Table Two below shows the mean and median ratios of EC to Tier One RBC for the entire test population, divided into four groups based upon asset size, as well as the standard deviation for each group.

EC to Tier One RBC Ratio

	Mean	**Median**	**STDEV**
Top Ten Banks	1.94	1.26	1.66
Large Banks	1.52	0.875	1.81
Mid-Size Banks	0.786	0.427	1.151
Small Banks	0.520	0.261	0.701
Micro Banks	0.541	0.207	1.341

Source: IRA Bank Monitor

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Basel II by the Numbers: Q1 2006

Description of the Metrics

Below is a description of the performance and Basel II metrics presented in this report. The measures in the profiles for individual BHCs are in thousands of US dollars unless otherwise indicated. All data is for the quarter ended March 2006.

- **Total Assets**: The total assets of the subsidiary banks in a given BHC. As reported in CALL/TFR.

- **Net Income**: Net income for the subsidiary banks, as reported in CALL/TFR.

- **ROA/ROE**: Return on assets and return on equity. This is an annualized measurement. Data is computed by IRA for BHC roll up's using a straight line annual factoring method. Unit level ROA/ROE data reported as computed by FDIC using RIS annual factoring formulae.

- **Loss Provisions Analysis**: Gross defaults suffered, loss provisions allocated, and the ratio of provisions to gross defaults. As reported in CALL/TFR.

- **Basel II Rating:** Actual default rate for current quarter expressed as bond rating equivalent using industry break points. Computed and assigned by IRA. This figure should generally align with the "internal target rating" for the bank's credit operations business model.

- **Defaults**: Observed loan and lease defaults in basis points versus the reported loan and lease base.

- **Loss Given Default** ("LGD"): Percent loss after default per dollar lent, calculated by comparing current period defaults with recoveries.

- **M:** Weighed average maturity or WAM in years for the aggregate lending portfolio.

- **Exposure at Default** ("EAD") = Amount in aggregate which obligors could borrow immediately prior to default expressed as % of existing credit available. Computed by analyzing as-reported unused lending commitments.

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Basel II by the Numbers: Q1 2006

- **Economic Capital**: EC is a way to measure the amount of capital needed to meet the losses from the risks which a bank assumes. In this report, standardized, fully-stressed EC is computed by IRA to enable direct comparisons between institution risk management strategies. Includes separate calculations and risk weightings for lending, trading and investment activities for each BHC or thrift.

- **Tier-One Risk-Based Capital**: The regulatory capital measure as reported by the institution to regulators. Tier One RBC is based on a regulated formula and in the case of BHCs is reported in Schedule RC-R of the CALL/TFR for their subsidiary banks.

- **EC to Tier One RBC**: Ratio of Economic Capital to Tier 1 RBC.

- **RAROC**: Risk Adjusted Return On Capital. Also known as Return On Economic Capital (ROEC). Computed using IRA's EC estimate.

Notes on Methodology

There is a degree of diversity of opinion as to how the metrics in Basel II should be calculated equal to that found among bank business models. Indeed, since our last report, we have received feedback on several areas of methodology:

- Our choice to treat the implied guarantee for GSE paper as a zero risk item for Economic Capital computations drew several comments. Many institutions use a 20% risk factor for GSE risk when calculating EC, a practice which is compliant with regulatory guidelines. Since everyone in the marketplace views GSEs as risk free, applying such a factor to a benchmark designed to highlight the differences in "business model" efficacy among institutions can mask the real world RAROC effects of significant amounts of capital and thus impede transparency. We have data showing the delta between the two viewpoints and are presently examining how to best express these for benchmarking purposes.

- We also received feedback on our choice to base our Exposure At Default (EAD) methodology that focuses on examining unused commitments. As one might expect, the reactions ranged from favorable to concerned in a manner that correlates to the degree to which the commenter's institution has such exposure and degree to which they mitigate that exposure using statistics to predict the likely use of these unused commitments ("UC ") by obligors. We note that these statistics are internally arbitrary and of

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sufficient variety so as to be hindrances to transparency if applied to a "business model" benchmarking tool. We examined the EAD data using a parametric approach but this just adds to the noise. We looked into creating a standard test case UC exposure distribution formula for but this only produces a basis for even more argument about the validity of the benchmark. So for now we are sticking with the simplistic but defendable rule that a contracted and unused commitment constitutes EAD.

- Lastly, we also received comments regarding our calculations for LGD, in both cases complaining, to quote one banker, that "I haven't lost money on a real estate loan in years." One commenter suggested that we compare gross defaults to provisions instead of recoveries to better capture the economic reality of the lending & recovery process. We are concerned that using provisions, rather than current period recoveries, to calculate LGD may add noise to the analysis, however, and thus we have retained our current definition for LGD in this report.

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Basel II by the Numbers: Q1 2006

SUMMARY BASEL II METRICS

The table below presents actual average and median current period P(D), LGD, M and EAD, divided into four groups, and including the standard deviation for each group. We also provide a smoothed average ("S") for LGD, replacing any negative values more than one standard deviation from the mean of the actual results with a four quarter average.

LARGE BANKS	P(D) (bp)	LGD (%)	M (yrs)	EAD (%)
MEAN	8.22	31.43%	3.86	74.01%
MEDIAN	5.60	66.10%	3.27	43.60%
STDEV	10.98	-253.50%	2.18	88.88%
S-MEAN		61.89%		
S-MEDIAN		67.15%		
S-STDEV		23.91%		

Source: IRA Bank Monitor

MID SIZE BANKS	P(D) (bp)	LGD (%)	M (yrs)	EAD (%)
MEAN	6.65	-35.67%	3.3935	38.21%
MEDIAN	3.90	59.75%	2.975	29.00%
STDEV	14.65	-506.75%	2.206	72.17%
S-MEAN		33.70%		
S-MEDIAN		60.10%		
S-STDEV		76.57%		

Source: IRA Bank Monitor

SMALL BANKS	P(D) (bp)	LGD (%)	M (yrs)	EAD (%)
MEAN	2.93	-25.13%	3.44	25.79%
MEDIAN	1.50	57.30%	2.99	24.00%
STDEV	4.85	-362.57%	2.02	10.94%
S-MEAN		36.68%		
S-MEDIAN		57.30%		
S-STDEV		76.76%		

Source: IRA Bank Monitor

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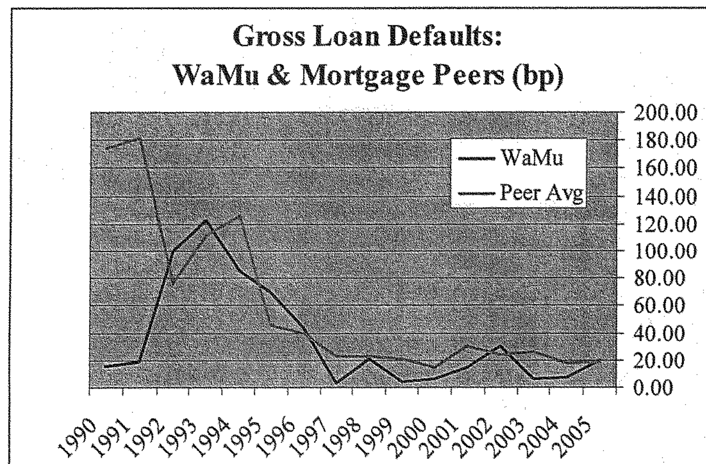
Basel II by the Numbers: Q1 2006

MICRO BANKS	P(D) (bp)	LGD (%)	M (yrs)	EAD (%)
MEAN	3.69	4.09%	3.27	23.32%
MEDIAN	2.15	66.00%	2.60	21.40%
STDEV	4.57	-314.13%	2.27	10.00%
S-MEAN		41.39%		
S-MEDIAN		55.74%		
S-STDEV		52.58%		

Source: IRA Bank Monitor

We believe that the frequency and magnitude of the negative LGD results in this simulation, as illustrated in the individual BHC profiles which follow starting on Page 11, support the view that loan collateral values have reached extraordinarily high levels and that defaults, conversely, are greatly skewed to the low-end of historical norms. Consider the chart below, which shows since 1990 the gross defaults for the lead unit of Washington Mutual (NYSE:WM) and the average of 40 other large members of the FDIC mortgage specialization peer group. The longer this abnormal situation persists, we believe, the more dramatic the likely reversion back to the historical mean is likely to be.



Source: IRA Bank Monitor

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Basel II by the Numbers: Q1 2006

LARGE HOLDING COMPANY	Total Assets (000)	Net Income YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
BANK OF AMERICA	$1,281,481,387	$4,876,468	1.52%	13.04%	$683,417,561	$1,115,634	$1,252,591	0.89:1
JPMORGAN CHASE & CO	$1,167,775,561	$2,890,395	0.99%	10.37%	$461,296,789	$879,600	$850,130	1.03:1
CITIGROUP	$1,030,820,869	$4,131,644	1.60%	16.95%	$643,625,809	$1,900,798	$1,115,617	1.70:1
WACHOVIA	$499,713,373	$1,530,960	1.23%	11.71%	$287,050,128	$104,554	$88,973	1.18:1
WELLS FARGO & COMPANY	$444,968,873	$1,660,229	1.49%	17.05%	$313,919,797	$316,126	$187,951	1.68:1
U S BANCORP	$213,518,811	$1,107,411	2.07%	20.45%	$140,710,938	$174,812	$116,800	1.50:1
SUNTRUST BANKS	$179,407,024	$557,751	1.24%	12.02%	$128,450,489	$54,235	$33,678	1.61:1
HSBC HOLDINGS PLC	$161,125,331	$413,107	1.03%	11.99%	$88,496,865	$229,890	$156,599	1.47:1
ROYAL BANK OF SCOTLAND	$159,913,200	$358,247	0.90%	6.37%	$103,874,452	$113,044	$79,999	1.41:1
NATIONAL CITY	$148,316,945	$419,263	1.13%	12.56%	$114,549,475	$178,101	$37,895	4.70:1
ABN AMRO HOLDING N V	$114,637,628	$275,397	0.96%	8.86%	$69,331,017	$15,146	$114,935	0.13:1
BB&T	$111,554,205	$442,702	1.59%	15.07%	$74,517,181	$42,066	$27,557	1.53:1
FIFTH THIRD BANK	$107,244,546	$381,367	1.42%	14.05%	$72,251,128	$96,716	$77,576	1.25:1
STATE STREET	$91,968,170	$268,472	1.17%	17.62%	$8,942,292	$0	$0	na
KEY CORP	$88,890,537	$281,033	1.26%	16.11%	$70,434,302	$64,550	$38,628	1.67:1
BANK OF NEW YORK	$88,793,175	$341,875	1.54%	15.17%	$33,114,609	$13,853	$6,620	2.09:1
PNC FINANCIAL SERVICES	$87,676,298	$258,748	1.18%	15.55%	$51,941,505	$28,758	$22,024	1.31:1
REGIONS FINANCIAL	$80,357,053	$261,341	1.30%	9.52%	$60,137,508	$55,231	$32,689	1.69:1
COUNTRYWIDE FINANCIAL	$79,951,833	$261,238	1.31%	18.79%	$71,235,319	$7,285	$27,586	0.26:1
CAPITAL ONE FINANCIAL	$75,140,274	$792,261	4.22%	27.59%	$42,573,405	$345,877	$78,772	4.39:1
BNP PARIBAS SA	$66,465,619	$196,652	1.18%	7.47%	$43,709,696	$27,383	$13,000	2.11:1
NORTH FORK BANK	$58,087,052	$221,620	1.53%	9.15%	$38,390,977	$8,834	$9,000	0.98:1
COMERICA	$57,078,819	$193,117	1.35%	13.83%	$44,862,945	$25,323	-$27	-937.89:1
ALLIED IRISH BANKS P L C	$55,418,707	$211,533	1.53%	13.13%	$40,858,598	$25,797	$18,000	1.43:1
MITSUBISHI UFJ FINANCIAL	$52,910,138	$188,093	1.42%	13.17%	$34,889,341	$10,253	$3,762	2.73:1
AMSOUTH BANK	$52,823,768	$181,677	1.38%	18.97%	$37,019,896	$50,571	$27,300	1.85:1
NORTHERN TRUST	$51,884,652	$182,213	1.40%	18.12%	$20,474,652	$366	$4,060	0.09:1

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Basel II by the Numbers: Q1 2006

LARGE HOLDING COMPANY	Total Assets (000)	Net Income YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
TORONTO-DOMINION BANK	$50,428,218	$108,438	0.86%	4.61%	$25,735,526	$12,197	$6,912	1.76:1
ZIONS BANK	$45,197,108	$153,427	1.36%	12.68%	$31,091,995	$15,610	$14,512	1.08:1
MARSHALL & ILSLEY	$44,548,189	$140,094	1.26%	14.44%	$34,865,178	$10,285	$10,845	0.95:1
COMMERCE BAN	$40,976,011	$77,831	0.76%	13.04%	$13,536,702	$6,096	$6,501	0.94:1
POPULAR	$38,345,183	$112,007	1.17%	15.56%	$23,190,966	$41,652	$33,334	1.25:1
MELLON FINANCIAL	$38,341,415	$164,612	1.72%	20.23%	$6,533,283	$229	-$842	-0.27:1
BANK OF MONTREAL	$37,733,714	$42,929	0.46%	5.46%	$25,539,277	$15,236	$5,646	2.70:1
DEUTSCHE BANK AG	$37,028,772	$37,810	0.41%	1.81%	$8,129,648	$0	-$50	0.00:1
FIRST HORIZON NATIONAL	$36,999,286	$228,410	2.47%	31.53%	$24,823,390	$14,791	$17,799	0.83:1
HUNTINGTON BANCSHARES	$35,241,416	$99,242	1.13%	18.07%	$26,294,495	$31,767	$16,419	1.93:1
COMPASS BANCSHARES	$32,847,235	$110,558	1.35%	15.78%	$23,310,167	$25,141	$17,112	1.47:1
SYNOVUS FINANCIAL	$30,141,139	$150,179	1.99%	16.38%	$22,624,930	$17,254	$19,549	0.88:1
NEW YORK COMMUNITY	$27,099,292	$74,793	1.10%	7.69%	$18,146,255	$99	$0	n/a
COLONIAL BANC	$21,918,735	$68,446	1.25%	12.94%	$16,516,306	$13,136	$12,342	1.06:1
ASSOCIATED BANC-	$21,267,941	$67,752	1.27%	11.30%	$15,391,054	$5,585	$3,717	1.50:1
ROYAL BANK OF CANADA	$20,541,202	$27,198	0.53%	3.29%	$12,800,334	$7,816	$5,355	1.46:1
FIRST BANK	$20,490,995	$2,711	0.05%	0.81%	$13,057,692	$19,605	$19,259	1.02:1
UBS AG	$19,009,426	$67,428	1.42%	12.85%	$8,233,919	$0	$0	n/a
BOK FINANCIAL	$18,787,797	$54,470	1.16%	14.21%	$9,200,798	$4,149	$1,854	2.24:1
CHARLES SCHWAB	$18,181,128	$56,030	1.23%	12.47%	$8,704,402	$56	$882	0.06:1
WEBSTER FINANCIAL	$17,667,592	$48,093	1.09%	11.00%	$12,791,853	$2,067	$1,573	1.31:1
MERCANTILE BANKSHARES	$17,094,476	$68,153	1.59%	13.65%	$11,715,334	$1,379	-$3,706	-0.37:1
W HOLDING COMPANY	$16,640,389	$35,030	0.84%	12.33%	$8,121,130	$5,364	$7,000	0.77:1
SKY FINANCIAL	$15,471,542	$48,032	1.24%	12.46%	$11,117,313	$10,681	$6,953	1.54:1
FIRST CITIZENS BANCSHARES	$15,154,744	$33,263	0.88%	9.68%	$10,019,557	$8,203	$7,635	1.07:1
FULTON FINANCIAL	$14,842,368	$46,145	1.24%	11.93%	$10,078,749	$1,504	$1,000	1.50:1
SOUTH FINANCIAL	$14,729,736	$30,031	0.82%	7.64%	$9,834,428	$8,874	$10,259	0.86:1
CITY NATIONAL	$14,554,937	$55,820	1.53%	15.66%	$9,567,152	$1,149	$0	n/a

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Basel II by the Numbers: Q1 2006

LARGE HOLDING COMPANY	Total Assets (000)	Net Income YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
LAURITZEN	$14,062,850	$37,489	1.07%	12.36%	$9,312,586	$17,407	$15,451	1.13:1
TCF FINANCIAL	$13,935,545	$58,052	1.67%	25.22%	$10,791,898	$3,116	$1,507	2.07:1
COMMERCE BANCSHARES	$13,692,836	$51,391	1.50%	19.66%	$9,127,876	$9,346	$4,432	2.11:1
FBOP	$13,573,710	$39,168	1.15%	9.70%	$9,612,312	$754	$110	6.85:1
NEW YORK PRIVATE BANK & TRUST	$13,196,486	$35,891	1.09%	13.41%	$6,441,046	$4	$1,748	0.00:1
INVESTORS FINANCIAL SERVICES	$12,433,965	$38,153	1.23%	18.63%	$308,021	$0	$0	n/a
VALLEY NATIONAL BANK	$12,281,514	$42,782	1.39%	16.47%	$8,163,699	$1,394	$1,294	1.08:1
BAN SOUTH	$11,875,044	$40,124	1.35%	14.54%	$7,434,110	$2,538	-$3	-846.00:1
CULLEN/FROST BANKERS	$11,686,145	$48,785	1.67%	18.80%	$6,521,631	$4,265	$3,934	1.08:1
DORAL FINANCIAL	$11,420,920	$26,415	0.93%	17.78%	$4,032,009	$971	$2,756	0.35:1
BANCO BILBAO VIZCAYA	$11,162,015	$11,234	0.40%	3.28%	$5,872,913	$15,993	$9,049	1.77:1
PEOPLE'S MUTUAL HOLDINGS	$11,085,026	$34,756	1.25%	10.64%	$8,774,871	$1,505	-$2	-752.50:1
R&G FINANCIAL	$11,020,025	$17,690	0.64%	7.88%	$6,940,322	$1,645	$5,637	0.29:1
BANK OF HAWAII	$10,577,291	$47,536	1.80%	29.69%	$6,268,879	$4,799	$2,735	1.75:1
WILMINGTON TRUST	$10,503,329	$41,131	1.57%	18.09%	$7,807,163	$3,211	$4,024	0.80:1
INTERNATIONAL BANCSHARES	$10,469,540	$26,247	1.00%	10.53%	$4,647,153	$5,630	$597	9.43:1
WHITNEY HOLDING	$10,287,413	$35,127	1.37%	16.55%	$6,514,648	$3,629	$2,000	1.81:1
FIRSTMERIT	$10,088,726	$29,337	1.16%	16.59%	$6,731,794	$14,907	$6,153	2.42:1

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Basel II by the Numbers: Q1 2006

LARGE HOLDING COMPANY	Benchmark Rating	P(D) (bp)	LGD %	M (yrs)	EAD %	Economic Capital	Tier 1 RBC	EC to Tier 1 RBC	RAROC %
BANK OF AMERICA	BBB	16.3	73.60%	6.58	177.20%	$146,994,026	$92,520,711	1.589	6.55%
JPMORGAN CHASE & CO	BBB	19.1	76.10%	3.07	186.00%	$390,198,992	$71,748,830	5.438	0.98%
CITIGROUP	BBB	29.5	69.40%	1.58	240.70%	$255,703,596	$75,677,896	3.379	2.31%
WACHOVIA	AA	3.6	58.80%	6.02	77.80%	$68,699,863	$32,402,167	2.12	5.80%
WELLS FARGO & COMPANY	A	10.1	73.00%	3.32	57.90%	$25,995,749	$28,048,666	0.927	12.94%
U S BAN	BBB	12.4	65.90%	3.96	95.20%	$8,971,860	$12,922,123	0.694	18.57%
SUNTRUST BANKS	A	4.2	40.90%	4.5	73.20%	$9,224,141	$12,054,618	0.765	13.57%
HSBC HOLDINGS PLC	BBB	26	69.70%	3.12	268.60%	$36,957,576	$10,813,005	3.418	1.22%
ROYAL BANK OF SCOTLAND	A	10.9	69.20%	6.63	44.10%	$6,283,783	$9,602,490	0.654	18.05%
NATIONAL CITY	BBB	15.5	69.80%	4.36	52.50%	$3,756,617	$9,965,411	0.377	18.04%
ABN AMRO HOLDING N V	AA	2.2	36.50%	4.32	60.40%	$4,611,232	$9,586,295	0.481	18.70%
BB&T	A	5.6	70.70%	4.48	38.90%	$1,576,416	$7,783,668	0.203	55.68%
FIFTH THIRD BANK	BBB	13.4	75.30%	3.77	57.40%	$3,894,618	$10,311,788	0.378	16.50%
STATE STREET	AAA	0	n/a	4.74	451.10%	$39,609,504	$4,844,238	8.177	1.68%
KEY	A	9.2	59.90%	3.35	55.90%	$3,852,501	$6,810,428	0.566	13.42%
BANK OF NEW YORK COMPANY	A	4.2	48.40%	4.64	116.40%	$29,923,807	$6,422,539	4.659	1.56%
PNC FINANCIAL SERVICES	A	5.5	64.00%	4.56	79.60%	$15,855,679	$6,041,068	2.625	3.47%
REGIONS FINANCIAL	A	9.2	61.30%	2.27	34.70%	$1,346,873	$6,884,161	0.196	48.97%
COUNTRYWIDE FINANCIAL	AA	1	91.50%	2.64	14.50%	$3,989,194	$5,649,619	0.706	10.56%
CAPITAL ONE FINANCIAL	BB	81.2	60.80%	2.54	374.30%	$6,329,899	$7,564,553	0.837	0.96%
BNP PARIBAS SA	A	6.3	62.80%	7.51	27.50%	$2,926,340	$5,261,473	0.556	18.05%
NORTH FORK BANK	AA	2.3	64.30%	6.16	15.50%	$4,161,072	$3,846,430	1.082	12.10%
COMERICA	A	5.6	66.30%	2.61	58.60%	$1,329,047	$5,549,172	0.24	24.56%
ALLIED IRISH BANKS P L C	A	6.3	65.20%	5.94	36.60%	$5,088,638	$3,500,200	1.454	8.91%
MITSUBISHI UFJ FINANCIAL	AA	2.9	77.00%	3.68	75.40%	$4,267,733	$5,373,022	0.794	10.85%

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Basel II by the Numbers: Q1 2006

LARGE HOLDING COMPANY	Benchmark Rating	P(D) (bp)	LGD %	M (yrs)	EAD %	Economic Capital	Tier 1 RBC	EC to Tier 1 RBC	RAROC %
AMSOUTH BANK	BBB	13.7	82.60%	4.05	59.80%	$6,679,358	$3,738,499	1.787	6.21%
NOR RN TRUST	AAA	0.2	20.50%	3.29	91.90%	$3,001,575	$3,422,164	0.877	5.37%
TORONTO-DOMINION BANK	A	4.7	50.40%	3.43	40.60%	$8,625,401	$2,950,827	2.923	4.94%
ZIONS BAN	A	5	74.60%	2.45	66.40%	$2,531,190	$2,864,384	0.884	15.07%
MARSHALL & ILSLEY	AA	2.9	56.50%	1.9	48.00%	$994,069	$3,138,924	0.317	29.23%
COMMERCE BAN	A	4.5	82.90%	5.65	40.60%	$18,116,850	$2,368,987	7.648	2.81%
POPULAR	BBB	18	65.70%	5.94	32.30%	$1,506,432	$2,557,848	0.589	20.57%
MELLON FINANCIAL	AAA	0.4	-18.80%	1.62	189.00%	$7,030,409	$2,997,607	2.345	2.17%
BANK OF MONTREAL	A	6	57.50%	3.27	54.80%	$918,116	$3,037,372	0.302	20.39%
DEUTSCHE BANK AG	AAA	0	n/a	0.62	76.30%	$6,091,434	$7,964,460	0.765	3.30%
FIRST HORIZON NATIONAL	A	6	76.40%	1.97	67.90%	$1,227,852	$2,480,785	0.495	17.69%
HUNTINGTON BANCSHARES	BBB	12.1	71.10%	3.02	31.80%	$3,181,235	$2,096,496	1.517	6.60%
COMPASS BANCSHARES	A	10.8	68.00%	3.02	43.60%	$2,717,244	$2,127,117	1.277	8.96%
SYNOVUS FINANCIAL	A	7.6	83.40%	1.48	33.40%	$181,526	$3,338,060	0.054	43.70%
NEW YORK COMMUNITY BAN	AAA	0.1	100.00%	4.4	6.70%	$3,533,847	$2,086,136	1.694	5.64%
COLONIAL BANC	A	8	74.30%	2.6	37.10%	$1,328,526	$1,518,710	0.875	14.84%
ASSOCIATED BANC-	AA	3.6	73.00%	2.41	35.20%	$417,168	$1,488,497	0.28	38.16%
ROYAL BANK OF CANADA	A	6.1	56.50%	3.21	42.20%	$2,864,836	$1,799,787	1.592	5.32%
FIRST BAN	BBB	15	84.60%	5.02	13.40%	$3,965,506	$1,259,972	3.147	4.46%
UBS AG	AAA	0	n/a	0.5	0.50%	$38,021	$2,101,067	0.018	622.64%
BOK FINANCIAL	A	4.5	38.20%	2.43	50.60%	$2,289,752	$1,356,428	1.688	6.32%
CHARLES SCHWAB	AAA	0.1	89.30%	4.77	36.30%	$3,851,042	$1,314,455	2.93	3.62%
WEBSTER FINANCIAL	AA	1.6	81.10%	8.48	41.80%	$2,247,134	$1,149,747	1.954	6.75%
MERCANTILE BANKSHARES	AA	1.2	-11.40%	3.99	42.20%	$158,022	$1,326,265	0.119	88.90%
W HOLDING COMPANY	A	6.6	58.20%	2.58	12.40%	$6,677,898	$1,133,621	5.891	2.05%
SKY FINANCIAL	A	9.6	75.20%	2.37	29.30%	$389,359	$1,207,387	0.322	34.57%
FIRST CITIZENS BANCSHARES	A	8.2	75.70%	3.06	50.70%	$529,032	$1,317,739	0.401	18.96%
FULTON FINANCIAL	AA	1.5	42.80%	3.07	42.30%	$161,129	$1,000,557	0.161	62.77%

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Basel II by the Numbers: Q1 2006

LARGE HOLDING COMPANY	Benchmark Rating	P(D) (bp)	LGD %	M (yrs)	EAD %	Economic Capital	Tier 1 RBC	EC to Tier 1 RBC	RAROC %
SOUTH FINANCIAL	A	9	76.70%	2.59	23.20%	$264,625	$965,206	0.274	37.01%
CITY NATIONAL	AA	1.2	-0.20%	5.58	48.70%	$634,551	$1,337,393	0.474	26.60%
LAURITZEN	BBB	18.7	68.10%	2.19	367.60%	$1,808,286	$1,044,127	1.732	3.73%
TCF FINANCIAL	AA	2.9	81.00%	8.17	31.10%	$66,561	$803,357	0.083	163.96%
COMMERCE BANCSHARES	A	10.2	47.20%	2.14	76.60%	$972,739	$1,038,986	0.936	9.80%
FBOP	AAA	0.8	77.30%	3.18	29.10%	$1,125,618	$1,467,530	0.767	13.22%
NEW YORK PRIVATE BANK & TRUST	AAA	0	-2050.00%	5.29	16.60%	$1,252,222	$1,063,442	1.178	10.58%
INVESTORS FINANCIAL SERVICES	AAA	0	0.00%	0.25	317.80%	$6,279,908	$760,657	8.256	2.10%
VALLEY NATIONAL BAN	AA	1.7	41.90%	7.47	32.90%	$1,517,061	$881,036	1.722	8.54%
BAN SOUTH	AA	3.4	63.90%	1.12	27.60%	$1,681,600	$950,982	1.768	6.25%
CULLEN/FROST BANKERS	A	6.5	58.40%	1.99	52.20%	$62,171	$824,333	0.075	198.08%
DORAL FINANCIAL	AA	2.4	89.10%	11.43	11.10%	$1,754,345	$778,747	2.253	6.65%
BANCO BILBAO VIZCAYA	BBB	27.2	51.10%	2.83	14.10%	$685,787	$683,627	1.003	12.73%
PEOPLE'S MUTUAL HOLDINGS	AA	1.7	-0.10%	2.63	36.30%	$415,895	$1,225,090	0.339	21.38%
R&G FINANCIAL	AA	2.4	71.20%	10.69	22.50%	$559,261	$813,869	0.687	14.71%
BANK OF HAWAII	A	7.7	57.50%	7.14	43.80%	$1,203,373	$664,691	1.81	9.77%
WILMINGTON TRUST	A	4.1	55.00%	1.89	41.50%	$475,336	$921,610	0.516	19.61%
INTERNATIONAL BANCSHARES	BBB	12.1	94.10%	2.4	33.30%	$31,122	$715,655	0.043	287.28%
WHITNEY HOLDING	A	5.6	77.70%	1.78	46.30%	$1,150,558	$730,559	1.575	9.79%
FIRSTMERIT	BBB	22.1	61.70%	3.98	43.50%	$304,906	$731,582	0.417	23.72%

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Basel II by the Numbers: Q1 2006

MID SIZE HOLDING COMPANY	Total Assets (000)	Net Income, YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
FIRST BANKS	$9,373,551	$34,632	1.48%	14.15%	$7,171,283	$3,445	$771	4.47:1
EAST WEST BANCORP	$9,275,439	$33,735	1.45%	13.68%	$7,652,336	$1	$2,728	0.00:1
ISRAEL DISCOUNT BANK	$9,078,960	$9,582	0.42%	7.01%	$2,844,514	$2,391	$3,023	0.79:1
CORUS BANKSHARES	$9,026,598	$45,687	2.02%	19.92%	$4,680,174	$20	$3,000	0.01:1
ARVEST BANK GROUP	$8,558,894	$20,498	0.96%	11.16%	$5,908,766	$2,607	$2,539	1.03:1
WINTRUST FINANCIAL CORP.	$8,483,652	$19,085	0.90%	8.71%	$5,532,016	$1,793	$1,537	1.17:1
FIRST MIDWEST BANCORP	$8,474,384	$30,571	1.44%	17.52%	$5,045,383	$2,306	$2,517	0.92:1
TRUSTMARK CORP.	$8,275,672	$28,926	1.40%	15.53%	$6,098,607	$2,835	$113	25.09:1
BANCO SANTANDER	$8,189,978	$10,582	0.52%	7.39%	$6,068,162	$4,672	$4,500	1.04:1
OLD NATIONAL BANCORP	$8,104,503	$21,184	1.05%	12.16%	$4,831,254	$7,395	$3,500	2.11:1
UCBH HOLDINGS	$7,975,884	$24,209	1.21%	13.02%	$6,059,820	$2,852	-$4	-713.00:1
STERLING FINANCIAL CORP.	$7,839,514	$17,290	0.88%	11.23%	$5,310,299	$1,594	$4,650	0.34:1
CITIZENS BANKING CORP.	$7,728,142	$22,645	1.17%	12.14%	$5,605,389	$6,233	$4,295	1.45:1
UMB FINANCIAL CORP.	$7,653,528	$13,663	0.71%	8.07%	$3,434,584	$4,025	$3,159	1.27:1
FIRSTBANK HOLDING CO	$7,620,348	$28,231	1.48%	23.19%	$2,342,305	$729	$755	0.97:1
METLIFE	$7,222,991	$3,595	0.20%	4.11%	$2,631,789	$0	$2,163	0.00:1
SUSQUEHANNA BANCSHARES	$7,214,871	$21,233	1.18%	10.82%	$5,047,172	$2,994	$2,600	1.15:1
PACIFIC CAPITAL BANCORP	$6,965,729	$68,766	3.95%	42.41%	$4,977,839	$64,787	$48,146	1.35:1
CATHAY GENERAL BANCORP	$6,867,231	$27,969	1.63%	13.16%	$4,991,513	$265	$1,233	0.21:1
NEWALLIANCE BANCSHARES	$6,862,872	$13,087	0.76%	4.73%	$3,551,922	$409	$0	n/a
IRWIN FINANCIAL CORP.	$6,850,269	$1,043	0.06%	0.60%	$5,177,835	$7,256	$9,193	0.79:1
UNITED BANKSHARES	$6,722,338	$24,325	1.45%	15.24%	$4,694,215	$671	$250	2.68:1
CENTRAL BANCOMPANY	$6,720,299	$21,393	1.27%	14.98%	$4,601,687	$2,286	$3,408	0.67:1
GREATER BAY BANCORP	$6,664,685	$27,070	1.62%	14.93%	$4,729,388	$2,094	-$7	-299.14:1

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MID SIZE HOLDING COMPANY	Total Assets (000)	Net Income, YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
TEXAS REGIONAL BANCSHARES	$6,625,777	$24,377	1.47%	14.04%	$4,142,521	$4,360	$4,871	0.90:1
CHITTENDEN CORP.	$6,594,728	$21,527	1.31%	12.52%	$4,620,572	$1,753	$1,533	1.14:1
OTTO BREMER FOUNDATION	$6,585,478	$17,561	1.07%	11.66%	$4,681,207	$996	$2,539	0.39:1
EASTERN BANK CORP.	$6,433,250	$21,599	1.34%	12.95%	$4,528,616	$1,427	$0	n/a
HANCOCK HOLDING COMPANY	$6,233,540	$21,515	1.38%	18.35%	$2,971,171	$3,922	$561	6.99:1
REPUBLIC BANCORP	$6,223,197	$17,687	1.14%	15.67%	$4,771,570	$1,720	$1,400	1.23:1
UNITED COMMUNITY BANKS	$6,154,350	$17,518	1.14%	13.93%	$4,602,610	$1,882	$3,499	0.54:1
PROVIDENT BANKSHARES	$6,096,083	$20,168	1.32%	16.49%	$3,720,477	$2,088	$318	6.57:1
ALABAMA NATIONAL	$6,048,541	$20,008	1.32%	15.24%	$4,267,779	$504	$1,243	0.41:1
BANK LEUMI LE-ISRAEL B.M.	$5,986,974	$5,381	0.36%	5.58%	$2,705,755	$3	$0	n/a
PROVIDENT FINANCIAL SERVICES	$5,912,304	$13,026	0.88%	5.54%	$3,731,348	$1,122	$555	2.02:1
FIRST COMMONWEALTH FINANCIAL	$5,889,008	$16,142	1.10%	11.34%	$3,651,757	$2,802	$908	3.09:1
MB FINANCIAL INC	$5,879,068	$18,888	1.29%	12.35%	$3,885,276	$1,426	$1,100	1.30:1
OCEAN BANKSHARES	$5,822,188	$22,553	1.55%	16.19%	$4,518,284	$689	$3,200	0.22:1
PARK NATIONAL CORP.	$5,679,315	$22,434	1.58%	26.46%	$3,310,930	$2,417	-$188	-12.86:1
FIRST CITIZENS BANCORP.	$5,566,811	$15,406	1.11%	11.79%	$3,655,335	$1,004	$424	2.37:1
CVB FINANCIAL CORP.	$5,521,063	$19,361	1.40%	19.06%	$2,717,127	$20	$250	0.08:1
F.N.B. CORP.	$5,473,599	$16,374	1.20%	11.31%	$3,718,786	$2,298	$1,390	1.65:1
UMPQUA HOLDINGS CORP.	$5,452,541	$19,293	1.42%	8.77%	$4,107,954	$613	$20	30.65:1
EGGEMEYER ADVISORY CORP.	$5,388,478	$26,833	1.99%	10.93%	$3,919,938	$558	$337	1.66:1
AMCORE FINANCIAL	$5,323,593	$12,243	0.92%	12.06%	$3,804,580	$3,101	$2,004	1.55:1
CENTRAL PACIFIC FINANCIAL	$5,240,562	$20,805	1.59%	10.87%	$3,654,840	$1,084	$525	2.06:1
INVESTORS BANCORP MHC	$5,239,002	$6,812	0.52%	4.24%	$2,625,375	$72	$200	0.36:1
NATIONAL PENN BANCSHARES	$5,069,003	$15,666	1.24%	10.14%	$3,412,710	$1,238	$680	1.82:1
SVB FINANCIAL GROUP	$5,054,576	$29,426	2.33%	22.28%	$2,730,217	$1,361	-$2	-680.50:1
WESTAMERICA BANCORP.	$5,017,273	$25,751	2.05%	22.72%	$2,639,968	$1,119	$150	7.46:1

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Basel II by the Numbers: Q1 2006

MID SIZE HOLDING COMPANY	Total Assets (000)	Net Income, YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
BOSTON PRIVATE FINANCIAL	$5,004,914	$12,555	1.00%	8.67%	$3,760,547	$558	$1,163	0.48:1
NBT BANCORP	$4,853,063	$13,468	1.11%	12.43%	$3,247,841	$2,950	$1,728	1.71:1
FIRST INTERSTATE BANCSYSTEM	$4,605,734	$16,383	1.42%	17.06%	$3,114,352	$1,101	$1,753	0.63:1
RABOBANK NEDERLAND	$4,589,545	$8,037	0.70%	3.36%	$3,440,260	$132	$1,452	0.09:1
SNBNY HOLDINGS LIMITED	$4,574,993	$6,249	0.55%	5.65%	$1,361,862	$0	-$2	0.00:1
BARCLAYS PLC	$4,534,024	$90,903	8.02%	28.72%	$2,423,446	$15,958	$30,220	0.53:1
ORIENTAL FINANCIAL GROUP	$4,525,326	$9,519	0.84%	13.78%	$950,744	$555	$951	0.58:1
WESBANCO	$4,330,062	$6,781	0.63%	5.45%	$2,942,535	$1,845	$2,641	0.70:1
FIRST CHARTER CORP.	$4,269,962	$12,130	1.14%	13.04%	$3,019,682	$1,229	$1,519	0.81:1
GOLD BANC CORP.	$4,205,494	-$831	-0.08%	-0.89%	$3,247,963	$10,067	$10,852	0.93:1
MERCANTIL SERVICIOS FIN.	$4,167,024	$11,125	1.07%	13.17%	$1,983,318	$524	$750	0.70:1
DICKINSON FINANCIAL CORP. II	$4,157,306	$22,822	2.20%	22.41%	$3,184,366	$1,921	$3,861	0.50:1
COMMUNITY BANK SYSTEM	$4,146,078	$10,163	0.98%	8.08%	$2,408,367	$3,859	$2,394	1.61:1
UNITE HERE	$4,106,926	$3,805	0.37%	9.48%	$1,589,748	$69	$150	0.46:1
PINNACLE BANCORP	$3,955,517	$16,910	1.71%	18.96%	$2,960,469	$469	$1,008	0.47:1
FIRST NATIONAL BANK HOLDING COMPANY	$3,827,739	$13,437	1.40%	15.88%	$3,137,756	$792	$640	1.24:1
MIZUHO FINANCIAL GROUP	$3,817,746	$13,581	1.42%	5.01%	$2,376,606	$0	-$1	0.00:1
GLACIER BANCORP	$3,816,482	$15,004	1.57%	14.33%	$2,568,131	$153	$1,151	0.13:1
STERLING BANCSHARES	$3,765,611	$11,319	1.20%	10.94%	$2,758,729	$2,146	$1,524	1.41:1
CHEMICAL FINANCIAL CORP.	$3,724,745	$12,080	1.30%	10.04%	$2,697,853	$715	$460	1.55:1
PRIVATEBANCORP	$3,667,912	$11,446	1.25%	13.13%	$2,795,972	$165	$2,253	0.07:1
CAPITOL BANCORP LTD.	$3,641,373	$8,417	0.92%	8.32%	$3,087,466	$1,855	$2,357	0.79:1
JOHNSON FINANCIAL GROUP	$3,591,167	$6,439	0.72%	9.55%	$2,871,846	$553	$2,106	0.26:1
PROSPERITY BANCSHARES	$3,562,028	$13,886	1.56%	10.38%	$1,561,467	$74	$120	0.62:1
HANMI FINANCIAL CORP.	$3,511,974	$16,000	1.82%	12.40%	$2,668,787	$1,328	$2,960	0.45:1
RIVERSIDE BANKING COMPANY	$3,473,611	$10,126	1.17%	16.72%	$2,157,945	$1,763	$2,625	0.67:1

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FIRST FINANCIAL BANCORP	$3,449,758	$5,526	0.64%	7.60%	$2,605,224	$3,266	$1,253	2.61:1
COMMUNITY BANKS	$3,411,062	$11,127	1.30%	8.72%	$2,290,720	$313	$500	0.63:1
INDEPENDENT BANK CORP.	$3,402,845	$10,741	1.26%	13.14%	$2,644,865	$1,764	$1,588	1.11:1
FIRST MERCHANTS CORP.	$3,387,450	$9,653	1.14%	9.30%	$2,496,655	$1,596	$1,726	0.92:1
1ST SOURCE CORP.	$3,374,955	$9,585	1.14%	9.99%	$2,511,689	$776	-$300	-2.59:1
FIRST NATIONAL BANK GROUP	$3,346,515	$11,515	1.38%	21.87%	$2,029,795	$1,942	$0	n/a
BANCFIRST CORP.	$3,318,381	$11,300	1.36%	14.80%	$2,306,270	$667	$681	0.98:1
SUN BANCORP INC	$3,281,342	$5,368	0.65%	5.41%	$2,214,630	$200	$625	0.32:1
TAYLOR CAPITAL GROUP	$3,243,072	$10,851	1.34%	15.04%	$2,391,825	$2,185	$900	2.43:1
S&T BANCORP	$3,191,265	$13,208	1.66%	17.02%	$2,548,884	$1,026	$1,500	0.68:1
TEXAS CAPITAL BANCSHARES	$3,190,516	$7,185	0.90%	11.07%	$2,393,292	$13	$0	n/a
HARLEYSVILLE NATIONAL CORP.	$3,168,302	$9,165	1.16%	12.94%	$2,003,450	$1,472	$1,200	1.23:1
ITLA CAPITAL CORP.	$3,145,802	$7,740	0.98%	11.30%	$2,663,107	$0	$740	0.00:1
BANNER CORP.	$3,116,468	$8,099	1.04%	11.31%	$2,570,531	$360	$1,200	0.30:1
STERLING FINANCIAL CORP.	$3,069,367	$11,021	1.44%	13.16%	$2,171,250	$908	$1,125	0.81:1
INTRUST FINANCIAL CORP.	$3,048,459	$12,257	1.61%	18.13%	$2,220,012	$803	$2,247	0.36:1
GREAT WESTERN BANCORP.	$3,017,783	$9,276	1.23%	14.20%	$2,328,624	$2,167	$1,978	1.10:1
KNBT BANCORP	$3,017,645	$6,481	0.86%	7.16%	$1,489,169	$836	$750	1.11:1
W.T.B. FINANCIAL CORP.	$3,005,026	$11,187	1.49%	16.94%	$2,404,595	$193	$1,802	0.11:1
WESTERN ALLIANCE BANCORP.	$3,002,976	$8,892	1.18%	16.39%	$1,946,505	$85	$542	0.16:1
COMMUNITY TRUST BANCORP	$2,958,042	$10,536	1.42%	13.81%	$2,102,603	$2,361	$0	n/a
CENTENNIAL BANK HOLDINGS	$2,953,152	$8,819	1.19%	5.44%	$2,058,077	$1,098	$8	137.25:1
YARDVILLE NATIONAL BANCORP	$2,951,919	$6,203	0.84%	11.43%	$1,990,285	$2,710	$2,350	1.15:1
FRONTIER FINANCIAL CORP.	$2,939,801	$15,610	2.12%	21.87%	$2,685,326	$33	$2,304	0.01:1

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FIRST BANKS	A	4.8	-0.10%	2.13	39.40%	$243,587	$799,987	0.304	34.45%
EAST WEST BANCORP	AAA	0	-4600.00%	2.79	25.50%	$49,320	$722,189	0.068	163.13%
ISRAEL DISCOUNT BANK	A	8.4	89.60%	0.99	43.80%	$2,079,634	$582,600	3.57	4.19%
CORUS BANKSHARES	AAA	0	-1530.00%	0.32	93.50%	$31,217	$916,303	0.034	388.05%
ARVEST BANK GROUP	A	4.4	58.20%	2.11	33.80%	$76,729	$527,036	0.146	96.19%
WINTRUST FINANCIAL CORP.	AA	3.2	81.00%	1.57	40.70%	$142,181	$709,097	0.201	45.36%
FIRST MIDWEST BANCORP	A	4.6	74.50%	2.34	33.80%	$339,924	$637,375	0.533	24.78%
TRUSTMARK CORP.	A	4.6	5.80%	4.28	29.20%	$423,625	$586,796	0.722	16.64%
BANCO SANTANDER	A	7.7	73.70%	8.57	23.40%	$188,609	$569,651	0.331	26.40%
OLD NATIONAL BANCORP	BBB	15.3	75.10%	3.53	28.20%	$508,150	$654,885	0.776	11.64%
UCBH HOLDINGS	A	4.7	95.80%	3.19	23.30%	$509,427	$649,571	0.784	14.28%
STERLING FINANCIAL CORP.	AA	3	90.00%	5.17	32.80%	$431,715	$540,447	0.799	17.09%
CITIZENS BANKING CORP.	A	11.1	63.80%	4.34	29.00%	$267,890	$687,547	0.39	23.22%
UMB FINANCIAL CORP.	A	11.7	82.10%	2.04	64.70%	$94,752	$657,466	0.144	45.89%
FIRSTBANK HOLDING CO	AA	3.1	72.00%	4.71	54.70%	$1,756,093	$475,074	3.696	5.71%
METLIFE	AAA	0	n/a	2.69	2.10%	$1,916,084	$385,273	4.973	3.22%
SUSQUEHANNA BANCSHARES	A	5.9	64.70%	3.44	27.30%	$109,905	$588,443	0.187	41.80%
PACIFIC CAPITAL BANCORP	BB	130.2	75.70%	5.01	29.00%	$169,601	$504,361	0.336	35.60%
CATHAY GENERAL BANCORP	AAA	0.5	9.10%	3.24	37.60%	$331,368	$616,119	0.538	22.23%
NEWALLIANCE BANCSHARES	AA	1.2	-92.20%	6.35	20.10%	$522,978	$629,419	0.831	11.31%
IRWIN FINANCIAL CORP.	BBB	14	62.00%	5.58	19.70%	$102,878	$687,884	0.15	49.56%
UNITED BANKSHARES	AA	1.4	23.20%	4.3	39.10%	$454,256	$536,302	0.847	13.08%
CENTRAL BANCOMPANY	A	5	52.20%	1.85	26.70%	$194,893	$488,691	0.399	29.29%
GREATER BAY BANCORP	A	4.4	2.10%	3.58	31.30%	$1,059,300	$796,865	1.329	6.78%
TEXAS REGIONAL BANCSHARES	A	10.5	89.10%	1.29	18.10%	$50,555	$503,560	0.1	132.59%
CHITTENDEN CORP.	AA	3.8	50.80%	3.79	27.10%	$405,969	$480,761	0.844	15.48%

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Basel II by the Numbers: Q1 2006

MID SIZE HOLDING COMPANY	Benchmark Rating	P(D) (bp)	LGD %	M (yrs)	EAD %	Economic Capital	Tier 1 RBC	EC to Tier 1 RBC	RAROC %
OTTO BREMER FOUNDATION	AA	2.1	58.70%	1.34	32.70%	$251,771	$524,630	0.48	21.25%
EASTERN BANK CORP.	AA	3.2	56.50%	3.92	32.70%	$158,562	$587,526	0.27	35.50%
HANCOCK HOLDING COMPANY	BBB	13.2	-2.80%	3.48	21.10%	$82,619	$425,615	0.194	80.68%
REPUBLIC BANCORP	AA	3.6	68.50%	5.34	22.50%	$460,846	$460,960	1	10.33%
UNITED COMMUNITY BANKS	A	4.1	66.20%	0.98	21.20%	$263,242	$403,832	0.652	22.79%
PROVIDENT BANKSHARES	A	5.6	57.60%	2.1	41.00%	$808,220	$504,288	1.603	7.63%
ALABAMA NATIONAL	AA	1.2	41.70%	1.82	31.80%	$585,874	$476,824	1.229	9.41%
BANK LEUMI LE-ISRAEL B.M.	AAA	0	-33.30%	0.57	50.40%	$937,673	$379,382	2.472	4.53%
PROVIDENT FINANCIAL SERVICES	AA	3	56.20%	6.98	20.60%	$472,342	$522,210	0.905	10.56%
FIRST COMMONWEALTH FINANCIAL	A	7.7	85.00%	5.25	25.40%	$288,179	$455,173	0.633	18.24%
MB FINANCIAL INC	AA	3.7	69.70%	1.87	31.80%	$98,759	$493,321	0.2	44.72%
OCEAN BANKSHARES	AA	1.5	-21.50%	0.89	27.20%	$569,257	$559,525	1.017	10.91%
PARK NATIONAL CORP.	A	7.3	-6.50%	2.35	24.80%	$215,636	$332,539	0.648	28.89%
FIRST CITIZENS BANCORP.	AA	2.7	67.80%	3.26	28.20%	$43,732	$390,631	0.112	103.21%
CVB FINANCIAL CORP.	AAA	0.1	-650.00%	6.37	35.80%	$138,925	$391,370	0.355	44.25%
F.N.B. CORP.	A	6.2	80.10%	5.59	22.30%	$822,688	$373,147	2.205	5.43%
UMPQUA HOLDINGS CORP.	AA	1.5	-104.40%	3.77	28.80%	$82,770	$484,112	0.171	69.41%
EGGEMEYER ADVISORY CORP.	AA	1.4	-16.80%	1.49	37.40%	$25,961	$481,334	0.054	268.74%
AMCORE FINANCIAL	A	8.2	65.40%	2.6	24.70%	$72,739	$417,931	0.174	57.70%
CENTRAL PACIFIC FINANCIAL	AA	3	37.30%	2.77	53.00%	$168,559	$477,564	0.353	32.77%
INVESTORS BANCORP MHC	AAA	0.3	66.70%	11.23	16.50%	$1,846,285	$651,837	2.832	2.73%
NATIONAL PENN BANCSHARES	AA	3.6	51.20%	5.02	32.70%	$210,558	$339,218	0.621	21.84%
SVB FINANCIAL GROUP	A	5	-0.10%	1.09	165.30%	$456,139	$557,667	0.818	19.96%
WESTAMERICA BANCORP.	A	4.2	20.60%	5.59	19.10%	$1,296,107	$303,845	4.266	4.29%
BOSTON PRIVATE FINANCIAL	AA	1.5	94.40%	4.42	29.70%	$71,440	$355,784	0.201	65.21%
NBT BANCORP	A	9.1	60.10%	2.96	15.90%	$142,111	$336,202	0.423	24.53%
FIRST INTERSTATE BANCSYSTEM	AA	3.5	51.80%	2.46	29.80%	$119,961	$355,013	0.338	39.22%

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RABOBANK NEDERLAND	AAA	0.4	40.90%	5.26	37.30%	$21,199	$585,810	0.036	185.00%
SNBNY HOLDINGS LIMITED	AAA	0	n/a	1.13	1.90%	$115,608	$443,521	0.261	22.76%
BARCLAYS PLC	BB	65.8	86.40%	0.69	727.40%	$646,882	$779,489	0.83	-14.77%
ORIENTAL FINANCIAL GROUP	A	5.8	80.40%	4.1	2.00%	$2,267,183	$308,793	7.342	2.16%
WESBANCO	A	6.3	70.80%	5.14	17.90%	$378,826	$357,729	1.059	8.69%
FIRST CHARTER CORP.	A	4.1	60.10%	3.71	39.70%	$26,967	$362,666	0.074	118.78%
GOLD BANC CORP.	BBB	31	97.20%	1.42	31.20%	$370,173	$357,237	1.036	3.88%
MERCANTIL SERVICIOS FIN.	AA	2.6	-157.60%	1.76	37.00%	$489,334	$347,597	1.408	10.85%
DICKINSON FINANCIAL CORP. II	A	6	63.00%	2.25	34.00%	$168,344	$379,264	0.444	20.36%
COMMUNITY BANK SYSTEM	BBB	16	59.40%	6.86	17.50%	$190,525	$281,824	0.676	22.07%
UNITE HERE	AAA	0.4	-66.70%	14.61	11.00%	$128,991	$241,432	0.534	31.88%
PINNACLE BANCORP	AA	1.6	72.90%	2.42	24.10%	$23,011	$316,698	0.073	152.33%
FIRST NATIONAL BANK HOLDING COMPANY	AA	2.5	54.50%	3.62	36.50%	$45,326	$343,892	0.132	61.79%
MIZUHO FINANCIAL GROUP	AAA	0	n/a	1.2	37.00%	$939,967	$1,084,271	0.867	2.74%
GLACIER BANCORP	AAA	0.6	-19.60%	4.28	28.20%	$38,156	$331,946	0.115	108.42%
STERLING BANCSHARES	A	7.8	76.30%	1.78	32.40%	$196,882	$334,737	0.588	20.62%
CHEMICAL FINANCIAL CORP.	AA	2.7	63.50%	3.8	19.20%	$120,894	$421,977	0.286	28.92%
PRIVATEBANCORP	AAA	0.6	87.90%	2.93	32.30%	$8,477	$275,933	0.031	383.94%
CAPITOL BANCORP LTD.	A	6	76.30%	2.08	23.80%	$23,388	$373,786	0.063	130.10%
JOHNSON FINANCIAL GROUP	AA	1.9	16.50%	2.58	37.00%	$220,490	$262,941	0.839	13.36%
PROSPERITY BANCSHARES	AAA	0.5	14.90%	3.77	24.50%	$1,073,880	$255,825	4.198	4.11%
HANMI FINANCIAL CORP.	A	5	91.90%	1.66	22.50%	$30,541	$304,192	0.1	121.24%
RIVERSIDE BANKING COMPANY	A	8.2	38.70%	5.43	14.80%	$314,662	$242,959	1.295	11.52%
FIRST FINANCIAL BANCORP	BBB	12.5	79.10%	4.08	21.10%	$46,341	$289,397	0.16	46.08%
COMMUNITY BANKS	AA	1.4	49.50%	5.27	27.30%	$123,809	$255,226	0.485	24.27%
INDEPENDENT BANK CORP.	A	6.7	64.00%	2.99	9.90%	$120,547	$252,123	0.478	23.02%
FIRST MERCHANTS CORP.	A	6.4	80.70%	3.25	24.80%	$38,315	$269,349	0.142	64.60%

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1ST SOURCE CORP.	AA	3.1	-90.20%	1.58	21.10%	$100,141	$368,629	0.272	21.86%
FIRST NATIONAL BANK GROUP	A	9.6	90.40%	2.46	15.70%	$32,968	$237,734	0.139	104.38%
BANCFIRST CORP.	AA	2.9	61.30%	2	24.80%	$52,272	$276,370	0.189	58.40%
SUN BANCORP INC	AAA	0.9	-50.50%	3.34	33.80%	$74,384	$243,304	0.306	35.44%
TAYLOR CAPITAL GROUP	A	9.1	77.60%	1.65	38.70%	$63,577	$277,429	0.229	49.33%
S & T BANCORP	A	4	65.30%	2.63	30.60%	$42,407	$260,138	0.163	61.58%
TEXAS CAPITAL BANCSHARES	AAA	0.1	-92.30%	0.88	37.50%	$71,185	$257,324	0.277	42.29%
HARLEYSVILLE NATIONAL CORP.	A	7.3	79.50%	5.14	37.10%	$105,003	$244,153	0.43	25.09%
ITLA CAPITAL CORP.	AAA	0	n/a	1.47	8.90%	$239,187	$271,527	0.881	9.78%
BANNER CORP.	AA	1.4	56.70%	3.57	39.30%	$152,151	$254,371	0.598	19.00%
STERLING FINANCIAL CORP.	A	4.2	76.50%	3.74	24.50%	$47,881	$279,210	0.171	36.79%
INTRUST FINANCIAL CORP.	AA	3.6	17.10%	1.37	77.50%	$44,830	$263,128	0.17	57.28%
GREAT WESTERN BANCORP.	A	9.3	85.00%	2.68	34.80%	$21,918	$236,762	0.093	111.59%
KNBT BANCORP	A	5.6	89.80%	8.59	24.80%	$199,704	$248,332	0.804	13.57%
W.T.B. FINANCIAL CORP.	AAA	0.8	-204.10%	2.57	53.50%	$28,355	$263,327	0.108	112.70%
WESTERN ALLIANCE BANCORP.	AAA	0.4	-91.80%	4.2	43.30%	$282,800	$226,978	1.246	11.02%
COMMUNITY TRUST BANCORP	A	11.2	58.50%	2.15	18.50%	$220,084	$247,512	0.889	11.43%
CENTENNIAL BANK HOLDINGS	A	5.3	43.30%	1.51	29.00%	$29,734	$219,130	0.136	92.10%
YARDVILLE NATIONAL BANCORP	BBB	13.6	98.20%	3.06	26.00%	$117,570	$229,929	0.511	22.05%
FRONTIER FINANCIAL CORP.	AAA	0.1	-363.60%	1.98	33.00%	$39,754	$283,924	0.14	87.31%

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SMALL HOLDING COMPANY	Total Assets (000)	Net Income YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
COMMUNITY BANKSHARES	$15,257	$2,892	1.16%	12.84%	$747,090	$632	$956	0.66:1
ALLIANCE FINANCIAL	$10,753	$1,632	0.65%	8.83%	$666,153	$1,070	$1,000	1.07:1
NATIONAL BANK OF INDIANAPOLIS	$9,766	$1,833	0.74%	11.38%	$677,093	$100	$411	0.24:1
FLORIDA COMMUNITY BANKS	$13,059	$5,323	2.15%	25.11%	$868,192	$37	$980	0.04:1
PACIFIC MERCANTILE BANCORP	$8,502	$1,964	0.80%	11.12%	$666,477	$15	$225	0.07:1
PORTER BANCORP	$10,971	$3,974	1.61%	14.15%	$807,736	$77	$376	0.20:1
PROSPERITY BANKING COMPANY	$10,434	$3,590	1.46%	21.31%	$671,251	$101	$522	0.19:1
STUPP BROS.	$9,463	$2,167	0.88%	9.49%	$590,644	$184	$100	1.84:1
GATEWAY FINANCIAL HOLDINGS	$10,678	$966	0.39%	3.75%	$783,614	$66	$1,200	0.06:1
LSB BANCSHARES	$14,155	$1,833	0.74%	7.93%	$754,976	$1,545	$1,407	1.10:1
CENTER BANCORP	$7,406	-$831	-0.34%	-3.53%	$500,567	$10	$0	n/a
OLNEY BANCSHARES OF TEXAS	$13,304	$6,483	2.66%	19.97%	$836,838	$102	$576	0.18:1
HEARTLAND BANCORP	$11,019	$4,215	1.73%	21.55%	$761,320	$440	$450	0.98:1
FIRST OF LONG ISLAND	$10,376	$2,845	1.17%	12.82%	$404,064	$3	$236	0.01:1
COMMERCE BANCSHARES CORP.	$12,185	$1,798	0.75%	7.70%	$340,262	$293	$150	1.95:1
CITIZENS NATIONAL BANC CORP.	$10,471	$3,146	1.32%	13.98%	$506,846	$14	$296	0.05:1
FIRST CO BANCORP	$7,905	$2,287	0.96%	13.54%	$810,355	$1	$80	0.01:1
ATBANCORP	$11,121	$2,933	1.23%	13.62%	$753,839	$40	$303	0.13:1
MINNEHAHA BANSHARES	$10,090	$2,287	0.96%	11.32%	$617,004	$81	$0	n/a
ACNB	$7,468	$1,374	0.58%	8.65%	$518,922	$2	$225	0.01:1
BANK OF KENTUCKY FINANCIAL	$10,942	$2,719	1.14%	11.27%	$749,601	$602	$400	1.51:1
OVERTON FINANCIAL	$11,335	$2,602	1.10%	11.68%	$692,387	$119	$495	0.24:1
ENTERPRISE BANCORP	$12,025	$2,379	1.00%	11.93%	$718,789	$2	$273	0.01:1
FSB MUTUAL HOLDINGS	$5,609	$1,644	0.69%	5.59%	$516,067	$0	$0	n/a
LEESPORT FINANCIAL CORP.	$10,512	$2,057	0.87%	8.93%	$686,039	$474	$200	2.37:1
PREMIERWEST BANCORP	$15,012	$3,542	1.51%	12.13%	$828,400	$45	$300	0.15:1

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BANTERRA CORP	$10,210	$3,680	1.57%	16.28%	$632,557	$145	$579	0.25:1
FIRST MUTUAL BANCORP OF ILLINOIS	$11,883	$5,655	2.43%	24.94%	$756,664	$301	$1,800	0.17:1
BERKSHIRE BANCORP	$5,622	$1,783	0.77%	6.87%	$306,917	$1	$45	0.02:1
PRINCETON NATIONAL BANCORP	$9,563	$1,981	0.85%	8.60%	$570,421	$236	$10	23.60:1
SMITHTOWN BANCORP	$11,512	$3,329	1.44%	17.66%	$745,169	$103	$600	0.17:1
COMMUNITY BANCORP	$11,816	$3,987	1.72%	14.55%	$724,962	$26	$885	0.03:1
TEMECULA VALLEY BANCORP	$18,812	$4,128	1.79%	18.65%	$799,099	$156	$314	0.50:1
GRANVALOR HOLDING LTD.	$7,885	$1,152	0.50%	4.14%	$540,436	$0	-$200	0.00:1
NORTH VALLEY BANCORP	$13,743	$3,162	1.38%	12.58%	$627,547	$52	$0	n/a
MACON BANCORP	$9,808	$2,716	1.19%	14.53%	$743,368	$124	$405	0.31:1
CENTERSTATE BANKS OF FLORIDA	$9,910	$2,353	1.03%	13.80%	$546,549	$311	$240	1.30:1
SOU ASTERN BANK FINANCIAL	$11,318	$2,551	1.12%	16.51%	$626,977	$418	$504	0.83:1
FIRST FINANCIAL HOLDINGS MHC	$5,188	$2,457	1.08%	10.94%	$582,492	$0	$150	0.00:1
PEOPLES FINANCIAL	$9,132	$2,543	1.13%	11.48%	$354,707	$148	$35	4.23:1
BENJAMIN FRANKLIN BANCORP	$7,338	$1,269	0.57%	5.52%	$621,763	$30	$6	5.00:1
BIG SANDY HOLDING COMPANY	$11,016	$3,945	1.77%	17.01%	$852,929	$23	$636	0.04:1
GREATER COMMUNITY BANCORP	$10,040	$2,852	1.28%	13.34%	$667,021	$117	$0	n/a
FIRST CITIZENS FINANCIAL CORP.	$8,305	$1,362	0.61%	5.89%	$533,053	$124	$140	0.89:1
MASSBANK CORP.	$5,772	$1,822	0.82%	7.33%	$257,260	$6	$0	n/a
SALIN BANCSHARES	$11,853	$4,795	2.15%	19.72%	$715,517	$341	$30	11.37:1
RAINIER PACIFIC FINANCIAL GROUP	$8,131	$764	0.34%	3.74%	$595,695	$311	$150	2.07:1
COMMUNITY FIRST BANCSHARES	$10,558	$1,973	0.89%	10.59%	$688,507	$193	$323	0.60:1
COMMUNITY BANCORP	$15,492	$4,001	1.80%	12.13%	$732,664	$16	$0	n/a
FLORENCE BANCORP MHC	$7,034	$1,227	0.56%	7.68%	$534,502	$23	$1	23.00:1
BANK OF CHOICE HOLDING CO.	$8,115	$2,102	0.96%	7.47%	$624,581	$51	$384	0.13:1
SNB BANCSHARES	$9,652	-$1	0.00%	0.00%	$598,740	$40	$0	n/a

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HNB	$10,642	$2,548	1.22%	10.25%	$619,068	$125	$200	0.63:1
FIRST CITIZENS BANCSHARES	$9,664	$2,335	1.12%	12.23%	$556,858	$109	$225	0.48:1
FIRST MID-ILLINOIS BANCSHARES	$9,951	$2,638	1.26%	13.78%	$641,860	$181	$193	0.94:1
INDEPENDENT ALLIANCE BANKS	$8,225	$2,330	1.12%	11.47%	$637,065	$112	$156	0.72:1
HOME FEDERAL BANCORP	$9,272	$1,861	0.89%	9.05%	$622,200	$120	$117	1.03:1
LSB FINANCIAL	$8,937	$892	0.43%	4.04%	$595,548	$227	$150	1.51:1
TAMPA BANKING COMPANY	$9,996	$2,465	1.18%	15.81%	$555,005	$235	$420	0.56:1
PREMIER BANCSHARES	$7,159	$1,706	0.82%	9.66%	$701,020	$7	$571	0.01:1
WOORI FINANCE HOLDINGS CO. LTD.	$12,116	$2,879	1.39%	12.54%	$585,368	$274	$300	0.91:1
VENTURE FINANCIAL GROUP	$10,244	$2,637	1.28%	10.71%	$626,696	$56	$150	0.37:1
CITYWIDE BANKS OF COLORADO	$12,090	$4,549	2.22%	27.12%	$647,581	$191	$810	0.24:1
WESTBANK	$6,586	$1,122	0.55%	7.19%	$441,863	$30	$0	n/a
FARMERS NATIONAL BANC CORP.	$7,174	$1,980	0.97%	11.05%	$511,174	$270	$110	2.45:1
PEOPLES BANCTRUST COMPANY	$9,240	$2,742	1.35%	14.20%	$535,818	$176	-$541	-0.33:1
FIRST WESTERN BANCORP	$9,188	$4,673	2.30%	24.87%	$649,816	$54	$0	n/a
FIRST BANCORP	$9,745	$3,001	1.48%	18.96%	$670,929	$198	$272	0.73:1
LNB BANCORP	$9,291	$1,416	0.70%	9.05%	$590,825	$295	$150	1.97:1
FIRST FARMERS AND MERCHANTS	$9,623	$1,697	0.84%	6.36%	$473,040	$110	$0	n/a
PACIFIC CONTINENTAL	$10,419	$3,134	1.55%	13.65%	$704,085	$11	$250	0.04:1
EASTERN VIRGINIA BANKSHARES	$8,670	$1,783	0.89%	10.58%	$595,952	$228	$114	2.00:1

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INTEGRITY BANCSHARES	$9,349	$2,677	1.22%	11.07%	$771,123	$0	$1,291	0.00:1
ALIANT FINANCIAL	$10,377	$2,847	1.30%	16.05%	$660,019	$124	$777	0.16:1
NEWMIL BANCORP	$7,528	$2,434	1.11%	15.71%	$516,293	$15	$0	n/a
FIRST COMMUNITY BANCSHARES	$51,098	$1,437	0.65%	11.60%	$299,734	$1,050	$821	1.28:1
SOUTH SHORE BANCORP MHC	$7,905	$1,431	0.65%	6.91%	$547,479	$27	$0	n/a
BANK OF HIGHLAND PARK FIN.	$5,776	$2,387	1.09%	11.21%	$781,640	$0	$150	0.00:1
SECURITY NATIONAL	$10,367	$3,030	1.39%	15.91%	$607,684	$26	$75	0.35:1
NEW FRONTIER BANCORP	$9,506	$3,234	1.48%	17.58%	$690,588	$177	$835	0.21:1
SILVER STATE BANCORP	$14,125	$4,809	2.21%	23.12%	$715,721	$0	$600	0.00:1
FIRST SOUTH BANCORP	$12,696	$4,370	2.01%	22.84%	$746,371	$41	$346	0.12:1
CNLBANCSHARES	$9,070	$1,559	0.72%	6.59%	$681,739	$0	$841	0.00:1
VILLAGES BAN	$8,698	$2,685	1.24%	19.32%	$312,146	$63	$447	0.14:1
AMERISERV FINANCIAL INC	$8,031	$419	0.19%	1.90%	$548,466	$183	$0	n/a
CUMMINS-AMERICAN CORP.	$7,843	$1,628	0.75%	7.80%	$508,448	$67	$0	n/a
FIRST CHESTER COUNTY	$10,577	$2,128	0.98%	12.41%	$685,607	$45	$3	15.00:1
REPUBLIC FIRST BANCORP	$10,553	$2,801	1.30%	15.65%	$701,910	$1,127	$1,313	0.86:1
NORTHRIM BANCORP	$12,977	$3,244	1.50%	14.61%	$716,086	$4	$54	0.07:1
CIVITAS BANKGROUP	$7,807	$1,151	0.54%	7.06%	$566,026	$356	$328	1.09:1
COPPERMARK BANCSHARES	$13,905	$3,514	1.64%	18.98%	$766,700	$379	$600	0.63:1
ABINGTON MUTUAL HOLDING CO.	$6,172	$1,742	0.81%	8.06%	$531,498	$17	$0	n/a
COLUMBIA BANCORP	$14,245	$4,077	1.91%	20.11%	$682,758	$570	$550	1.04:1
SPIRIT BANKCORP	$11,409	$1,772	0.83%	11.83%	$656,533	$906	$750	1.21:1
MONTGOMERY BAN	$7,118	$2,220	1.05%	12.78%	$613,231	$11	$321	0.03:1
MERIDIAN FINANCIAL SERVICES	$7,054	$1,809	0.85%	6.88%	$490,733	$0	$69	0.00:1
NATIONAL BANKSHARES	$9,476	$3,058	1.45%	13.60%	$490,303	$87	$17	5.12:1
SHORE BANCSHARES	$10,743	$3,019	1.43%	13.57%	$641,271	$176	$312	0.56:1
CITRUS & CHEMICAL BANK	$9,274	$2,259	1.07%	17.47%	$421,534	$78	$180	0.43:1
AMES NATIONAL	$7,156	$2,692	1.28%	13.81%	$445,854	$27	$29	0.93:1

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SMALL HOLDING COMPANY	Benchmark Rating	P(D) (bp)	LGD %	M (yrs)	EAD %	Economic Capital	Tier 1 RBC	EC to Tier 1 RBC	RAROC %
BANTERRA CORP	AA	2.3	49.70%	3.1	15.40%	$16,163	$84,325	0.192	52.76%
FIRST MUTUAL BANCORP OF ILLINOIS	AA	4	95.70%	1.94	14.70%	$10,156	$90,421	0.112	81.46%
BERKSHIRE BANCORP	AAA	0	-400.00%	8.95	6.80%	$49,335	$93,305	0.529	21.60%
PRINCETON NATIONAL BANCORP	A	4.1	83.50%	1.89	22.30%	$17,572	$64,168	0.274	44.09%
SMITHTOWN BANCORP	AA	1.4	11.70%	2.58	31.20%	$3,500	$73,037	0.048	243.81%
COMMUNITY BANCORP	AAA	0.4	3.80%	1.74	29.80%	$6,858	$86,935	0.079	157.03%
TEMECULA VALLEY BANCORP	AA	2	99.40%	0.87	48.10%	$3,616	$87,712	0.041	331.73%
GRANVALOR HOLDING LTD.	AAA	0	n/a	4.46	13.50%	$39,945	$113,301	0.353	16.01%
NORTH VALLEY BANCORP	AAA	0.8	61.50%	4.6	33.00%	$24,205	$84,985	0.285	31.30%
MACON BANCORP	AA	1.7	55.60%	5.8	22.70%	$2,934	$75,752	0.039	258.90%
CENTERSTATE BANKS OF FLORIDA	A	5.7	91.00%	3.14	17.00%	$1,375	$64,954	0.021	622.56%
SOU ASTERN BANK FINANCIAL	A	6.7	38.00%	2.78	28.50%	$24,793	$64,232	0.386	33.39%
FIRST FINANCIAL HOLDINGS MHC	AAA	0	n/a	9.35	8.00%	$82,927	$79,338	1.045	8.91%
PEOPLES FINANCIAL	A	4.2	17.60%	1.69	34.60%	$196,031	$90,868	2.157	5.08%
BENJAMIN FRANKLIN BANCORP	AAA	0.5	36.70%	4.74	20.40%	$4,161	$57,189	0.073	136.64%
BIG SANDY HOLDING COMPANY	AAA	0.3	-47.80%	0.92	21.30%	$4,759	$92,757	0.051	209.87%
GREATER COMMUNITY BANCORP	AA	1.8	64.10%	4.8	27.30%	$60,953	$74,622	0.817	14.14%
FIRST CITIZENS FINANCIAL CORP.	AA	2.3	57.30%	3.23	22.20%	$25,429	$93,898	0.271	33.13%
MASSBANK CORP.	AAA	0.2	100.00%	8.97	13.50%	$12,159	$103,159	0.118	77.86%
SALIN BANCSHARES	A	4.8	81.20%	1.83	24.00%	$13,380	$93,528	0.143	65.81%
RAINIER PACIFIC FINANCIAL GROUP	A	5.2	83.60%	5.02	23.70%	$184,728	$79,042	2.337	3.86%
COMMUNITY FIRST BANCSHARES	AA	2.8	-6.70%	2.74	23.90%	$11,042	$74,772	0.148	76.85%
COMMUNITY BANCORP	AAA	0.2	-518.80%	1.17	30.30%	$9,383	$86,804	0.108	121.38%
FLORENCE BANCORP MHC	AAA	0.4	21.70%	7.57	22.20%	$13,934	$69,010	0.202	51.45%
BANK OF CHOICE HOLDING CO.	AAA	0.8	39.20%	2.19	26.00%	$20,124	$72,223	0.279	33.59%
SNB BANCSHARES	AAA	0.7	-157.50%	4.48	17.90%	$104,361	$101,116	1.032	8.80%
INTEGRITY BANCSHARES	AAA	0	n/a	0.43	30.80%	$9,765	$97,921	0.1	91.23%
ALIANT FINANCIAL	AA	1.9	23.40%	1.91	22.00%	$29,355	$73,551	0.399	30.29%

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COMMUNITY BANKSHARES	A	8.5	86.70%	2.15	12.60%	$32,989	$89,388	0.369	24.34%
ALLIANCE FINANCIAL	BBB	16.1	85.50%	6.97	15.30%	$6,806	$66,560	0.102	88.79%
NATIONAL BANK OF INDIANAPOLIS	AA	1.5	-34.00%	1.26	42.10%	$86,914	$65,627	1.324	8.68%
FLORIDA COMMUNITY BANKS	AAA	0.4	64.90%	0.69	27.40%	$55,093	$84,794	0.65	21.82%
PACIFIC MERCANTILE BANCORP	AAA	0.2	86.70%	3.97	30.90%	$19,245	$75,001	0.257	50.93%
PORTER BANCORP	AAA	1	7.80%	2.22	15.80%	$8,241	$89,405	0.092	110.45%
PROSPERITY BANKING COMPANY	AA	1.5	82.20%	5.92	27.70%	$21,827	$69,870	0.312	46.66%
STUPP BROS.	AA	3.1	72.30%	2.95	29.90%	$8,833	$95,734	0.092	102.34%
GATEWAY FINANCIAL HOLDINGS	AAA	0.8	90.90%	1.5	24.80%	$3,203	$95,523	0.034	223.39%
LSB BANCSHARES	BBB	20.5	94.20%	2.86	29.30%	$36,746	$93,514	0.393	20.21%
CENTER BANCORP	AAA	0.2	10.00%	5.99	31.40%	$206,131	$80,170	2.571	5.08%
OLNEY BANCSHARES OF TEXAS	AA	1.2	38.20%	1.16	34.90%	$12,110	$101,323	0.12	85.16%
HEARTLAND BANCORP	A	5.8	96.10%	1.88	21.10%	$5,464	$76,664	0.071	142.64%
FIRST OF LONG ISLAND	AAA	0.1	100.00%	6.51	20.80%	$225,620	$89,743	2.514	5.54%
COMMERCE BANCSHARES CORP.	A	8.6	70.30%	3.62	35.00%	$23,479	$94,403	0.249	38.83%
CITIZENS NATIONAL BANC CORP.	AAA	0.3	-114.30%	2.87	19.40%	$311,603	$90,931	3.427	3.37%
FIRST CO BANCORP	AAA	0	100.00%	5.27	8.60%	$394	$65,626	0.006	1650.42%
ATBANCORP	AAA	0.5	62.50%	2.02	41.50%	$2,138	$84,631	0.025	342.22%
MINNEHAHA BANSHARES	AA	1.3	-1.20%	5.09	53.40%	$11,127	$83,842	0.133	69.82%
ACNB	AAA	0	- 1800.00%	6.07	19.10%	$64,727	$69,314	0.934	13.07%
BANK OF KENTUCKY FINANCIAL	A	8	98.30%	1.45	30.00%	$17,274	$84,449	0.205	39.14%
OVERTON FINANCIAL	AA	1.7	13.40%	2.89	17.00%	$7,942	$86,087	0.092	91.88%
ENTERPRISE BANCORP	AAA	0	-100.00%	2.71	37.90%	$14,253	$73,873	0.193	72.61%
FSB MUTUAL HOLDINGS	AAA	0	n/a	3.08	19.30%	$11,092	$119,504	0.093	70.75%
LEESPORT FINANCIAL CORP.	A	6.9	97.90%	6.23	39.40%	$40,552	$66,090	0.614	15.94%
PREMIERWEST BANCORP	AAA	0.5	-2.20%	3.34	21.30%	$17,868	$93,943	0.19	63.13%

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FIRST CITIZENS BANCSHARES	AA	2	30.30%	3.31	31.50%	$11,318	$64,981	0.174	64.71%
FIRST MID-ILLINOIS BANCSHARES	AA	2.8	61.90%	3.84	18.20%	$9,916	$66,886	0.148	72.39%
INDEPENDENT ALLIANCE BANKS	AA	1.8	39.30%	2.13	15.30%	$5,041	$65,669	0.077	138.61%
HOME FEDERAL BANCORP	AA	1.9	83.30%	4	25.80%	$10,730	$82,406	0.13	59.06%
LSB FINANCIAL	AA	3.8	42.30%	5.62	17.70%	$33,338	$66,208	0.504	20.87%
TAMPA BANKING COMPANY	A	4.2	67.70%	2.03	58.00%	$113,535	$61,231	1.854	7.93%
PREMIER BANCSHARES	AAA	0.1	-171.40%	0.95	17.80%	$11,772	$72,095	0.163	54.82%
WOORI FINANCE HOLDINGS CO. LTD.	A	4.7	99.30%	2.5	0.90%	$37,024	$68,656	0.539	24.09%
VENTURE FINANCIAL GROUP	AAA	0.9	-216.10%	2.36	24.70%	$19,234	$72,923	0.264	39.61%
CITYWIDE BANKS OF COLORADO	AA	2.9	84.30%	1.4	33.00%	$28,591	$68,040	0.42	28.27%
WESTBANK	AAA	0.7	86.70%	4.61	25.90%	$140,972	$54,635	2.58	5.56%
FARMERS NATIONAL BANC CORP.	A	5.3	37.00%	4.86	14.60%	$10,460	$74,213	0.141	67.80%
PEOPLES BANCTRUST COMPANY	AA	3.3	-54.50%	3.01	20.60%	$18,568	$74,618	0.249	40.56%
FIRST WESTERN BANCORP	AAA	0.8	63.00%	2.42	23.10%	$12,623	$75,708	0.167	59.99%
FIRST BANCORP	AA	3	32.30%	2.99	24.90%	$22,264	$61,759	0.36	31.26%
LNB BANCORP	A	5	69.20%	2.95	23.10%	$4,567	$63,082	0.072	138.64%
FIRST FARMERS AND MERCHANTS	AA	2.3	57.30%	4.96	16.90%	$85,709	$98,366	0.871	8.71%
PACIFIC CONTINENTAL	AAA	0.2	-418.20%	3.34	26.90%	$19,185	$68,213	0.281	44.50%
EASTERN VIRGINIA BANKSHARES	AA	3.8	38.20%	4.43	16.10%	$27,697	$62,609	0.442	21.61%

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NEWMIL BANCORP	AAA	0.3	53.30%	7.44	20.70%	$20,684	$58,167	0.356	41.86%
FIRST COMMUNITY BANCSHARES	BBB	35	69.90%	3.47	5.80%	$14,831	$55,481	0.267	-70.84%
SOUTH SHORE BANCORP MHC	AAA	0.5	-18.50%	4.46	24.40%	$58,743	$80,788	0.727	14.05%
BANK OF HIGHLAND PARK FIN.	AAA	0	n/a	2.48	13.60%	$12,626	$85,492	0.148	48.00%
SECURITY NATIONAL	AAA	0.4	19.20%	3.61	37.90%	$39,048	$75,908	0.514	16.42%
NEW FRONTIER BANCORP	AA	2.6	92.70%	1.35	17.60%	$5,400	$73,837	0.073	150.56%
SILVER STATE BANCORP	AAA	0	n/a	1.69	35.70%	$5,018	$83,657	0.06	239.46%
FIRST SOUTH BANCORP	AAA	0.5	7.30%	2.59	27.00%	$3,423	$72,902	0.047	303.34%
CNLBANCSHARES	AAA	0	n/a	1.14	53.50%	$1,703	$95,574	0.018	493.68%
VILLAGES BAN	AA	2	88.90%	3.13	61.90%	$26,043	$61,940	0.42	45.31%
AMERISERV FINANCIAL INC	AA	3.3	63.90%	3.35	19.20%	$38,356	$81,216	0.472	15.90%
CUMMINS-AMERICAN CORP.	AA	1.3	88.10%	4.66	28.70%	$187,528	$85,653	2.189	4.12%
FIRST CHESTER COUNTY	AAA	0.7	-60.00%	3.99	37.50%	$19,604	$70,639	0.278	39.68%
REPUBLIC FIRST BANCORP	BBB	16.1	100.00%	4.15	29.90%	$26,215	$71,589	0.366	29.79%
NORTHRIM BANCORP	AAA	0.1	- 2750.00%	1.71	20.70%	$14,223	$82,109	0.173	72.10%
CIVITAS BANKGROUP	A	6.3	14.60%	1.68	27.80%	$117,488	$67,487	1.741	5.95%
COPPERMARK BANCSHARES	A	4.9	77.30%	1.62	52.90%	$8,854	$74,229	0.119	76.71%
ABINGTON MUTUAL HOLDING CO.	AAA	0.3	70.60%	9.94	25.00%	$80,273	$89,720	0.895	8.42%
COLUMBIA BANCORP	A	8.3	91.20%	1.66	34.20%	$23,329	$73,954	0.315	42.72%
SPIRIT BANKCORP	BBB	13.8	97.80%	1.5	24.10%	$7,794	$59,311	0.131	74.68%
MONTGOMERY BAN	AAA	0.2	81.80%	0.97	19.20%	$20,873	$71,765	0.291	31.60%
MERIDIAN FINANCIAL SERVICES INC	AAA	0	n/a	5.16	20.10%	$235,607	$104,898	2.246	3.27%
NATIONAL BANKSHARES	AA	1.8	56.30%	5.4	23.80%	$129,055	$75,001	1.721	6.47%
SHORE BANCSHARES	AA	2.7	74.40%	1.77	32.90%	$15,469	$85,799	0.18	52.01%
CITRUS & CHEMICAL BANK	AA	1.9	42.30%	2.77	41.60%	$65,049	$54,935	1.184	14.02%
AMES NATIONAL	AAA	0.6	48.10%	3.07	17.80%	$57,433	$80,081	0.717	13.04%
HNB	AA	2	68.80%	2.79	20.40%	$20,901	$99,534	0.21	38.99%

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MICRO HOLDING COMPANY	Total Assets (000)	Net Income, YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
SOUTHCOAST FINANCIAL	$487,475	$1,245	1.02%	10.82%	$375,299	$64	$222	0.29:1
MID ILLINOIS BANCORP	$487,371	$1,398	1.15%	10.96%	$319,521	$21	$105	0.20:1
NEXTIER INCORPORATED	$486,322	$902	0.74%	6.30%	$325,149	$17	$150	0.11:1
FIRST COMMUNITY	$486,049	$1,116	0.92%	7.11%	$229,621	$45	$120	0.38:1
CAPITAL BANCORP	$484,846	$1,132	0.93%	12.06%	$408,790	$77	$428	0.18:1
CITIZENS BANCSHARES OF BATESVILLE	$484,584	$1,055	0.87%	10.37%	$302,127	$576	$100	5.76:1
BANKERS' BANCORP	$484,266	$763	0.63%	7.70%	$167,373	$1	$30	0.03:1
CODORUS VALLEY BANCORP	$483,735	$1,438	1.19%	15.07%	$375,834	$7	$210	0.03:1
COMMUNITY CENTRAL BANK	$483,320	$972	0.80%	9.02%	$356,140	$38	$50	0.76:1
PULASKI INVESTMENT	$482,851	$632	0.52%	6.57%	$351,319	$114	$0	n/a
WHITCORP FINANCIAL COMPANY	$482,661	$2,100	1.74%	16.28%	$322,731	$110	$0	n/a
BCB BANCORP	$482,526	$1,390	1.15%	11.32%	$313,066	$67	$250	0.27:1
BRANNEN BANKS OF FLORIDA	$481,986	$2,187	1.81%	31.72%	$312,322	$2	($7)	-0.29:1
OXFORD FINANCIAL	$481,897	$1,719	1.43%	16.16%	$385,384	$6	$0	n/a
CONNECTICUT MUTUAL HOLDING COMPANY	$481,830	$475	0.39%	4.48%	$262,911	$4	$11	0.36:1
FIRST FARMERS FINANCIAL	$481,691	$1,713	1.42%	12.89%	$365,624	$172	$535	0.32:1
COMMUNITY BANC-CORP OF SHEBOYGAN	$481,645	$455	0.38%	4.70%	$364,774	$475	$369	1.29:1
FCB BANCORP	$480,702	$1,112	0.93%	7.88%	$353,573	$0	$153	0.00:1
1ST CENTENNIAL BANCORP	$480,280	$2,073	1.73%	15.94%	$397,624	$119	$465	0.26:1
GUARANTY FEDERAL BANCSHARES	$479,016	$1,864	1.56%	13.08%	$446,307	$32	$225	0.14:1
COMMERCIAL HOLDING COMPANY	$478,232	$2,018	1.69%	19.38%	$322,229	$76	$231	0.33:1
S.B.C.P. BANCORP	$478,105	$1,082	0.91%	10.65%	$377,521	$48	$200	0.24:1
FAUQUIER BANKSHARES	$477,249	$1,528	1.28%	15.24%	$401,405	$74	$120	0.62:1

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MICRO HOLDING COMPANY	Total Assets (000)	Net Income, YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
PACIFIC FINANCIAL	$499,644	$1,723	1.38%	13.07%	$401,908	$100	$0	n/a
MIDSTATE BANCORP	$497,721	$2,762	2.22%	24.33%	$397,694	$30	$386	0.08:1
DNB FINANCIAL	$496,661	$641	0.52%	6.51%	$308,863	$129	$0	n/a
FARMERS ENTERPRISES	$496,448	$2,197	1.77%	19.08%	$240,287	$15	$0	n/a
PSB GROUP	$495,426	$761	0.61%	7.03%	$373,008	$208	$188	1.11:1
PLATTE VALLEY FINANCIAL	$494,361	$1,242	1.00%	10.75%	$422,434	$328	$262	1.25:1
PARAGON COMMERCIAL	$494,032	$1,465	1.19%	14.97%	$398,406	$15	$426	0.04:1
SABINE BANCSHARES	$493,830	$1,842	1.49%	20.66%	$329,991	$204	$225	0.91:1
SECURITY NATIONAL	$493,667	$2,244	1.82%	21.90%	$367,103	$307	$81	3.79:1
BEACH COMMUNITY BANCSHARES	$492,089	$1,578	1.28%	16.48%	$393,961	$0	$512	0.00:1
FIRST NATIONAL	$491,922	$1,620	1.32%	17.17%	$393,812	$59	$85	0.69:1
CENTRAL BANk	$490,772	$3,420	2.79%	16.23%	$303,811	$101	$450	0.22:1
SHINHAN FINANCIAL GROUP	$490,631	$890	0.73%	5.73%	$375,484	$0	$150	0.00:1
MAGNOLIA BANKING	$490,615	$2,229	1.82%	18.70%	$307,409	$333	$204	1.63:1
SOU RN BANCORP INC	$490,415	$1,281	1.04%	9.97%	$239,533	$113	$60	1.88:1
STOCKMENS FINANCIAL	$489,915	$1,507	1.23%	12.07%	$354,754	$78	$138	0.57:1
HERITAGE OAKS BANCORP	$489,438	$1,801	1.47%	13.86%	$380,188	$0	$120	0.00:1
PEOPLES BAN	$489,173	$1,248	1.02%	12.42%	$381,546	$71	$237	0.30:1
NATIONAL BANCSHARES	$488,938	$1,319	1.08%	10.70%	$374,183	$775	$390	1.99:1
NATIONAL MERCANTILE BANCORP	$488,852	$1,570	1.28%	12.85%	$353,499	$0	$32	0.00:1
FIDELITY COMPANY	$488,817	$1,041	0.85%	9.50%	$389,232	$56	$10	5.60:1
INDEPENDENT HOLDINGS INC	$488,436	$365	0.30%	3.14%	$423,354	$508	$452	1.12:1
BLUE RIDGE BANCSHARES	$488,143	$823	0.67%	7.86%	$337,854	$292	$190	1.54:1

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Basel II by the Numbers: Q1 2006

MICRO HOLDING COMPANY	Total Assets (000)	Net Income, YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
BANCSHARES								
INDUSTRY BANCSHARES	$465,086	$1,423	1.22%	13.75%	$194,184	$364	$55	6.62:1
HOMESTAR FINANCIAL GROUP	$464,821	$691	0.59%	9.03%	$324,807	$10	$0	n/a
WEST POINTE BANCORP	$464,590	$879	0.76%	10.14%	$258,264	$103	$0	n/a
INTER-MOUNTAIN BANCORP.	$464,396	$2,528	2.18%	23.09%	$291,243	$2	$0	n/a
PUTNAM-GREENE FINANCIAL	$464,066	$1,918	1.65%	17.11%	$302,975	$80	$60	1.33:1
INTERNATIONAL BRO RHOOD OF BOILERMAKERS IRON SHIP BUILDERS BLACKSMITHS FORG	$462,448	$837	0.72%	7.59%	$180,449	$53	$70	0.76:1
PUTNAM BANCSHARES	$461,105	$1,337	1.16%	9.20%	$267,514	$256	$150	1.71:1
FIRST LITCHFIELD FINANCIAL	$460,169	$719	0.62%	10.01%	$246,755	$2	$105	0.02:1
PALOS BANCSHARES	$459,734	$1,673	1.46%	19.14%	$231,223	$31	$117	0.26:1
AMERICAN COMMUNITY BANCSHARES	$458,895	$1,320	1.15%	11.20%	$350,511	$76	$272	0.28:1
ST. JOSEPH CAPITAL	$458,516	$656	0.57%	7.43%	$345,953	$0	$0	n/a
WEST ALABAMA CAPITAL CORP.	$458,246	$1,392	1.22%	10.87%	$255,227	$185	$165	1.12:1
CROGHAN BANCSHARES	$455,999	$1,432	1.26%	12.19%	$338,298	$165	$35	4.71:1
B.P.C.	$454,197	$1,399	1.23%	17.89%	$240,634	$127	$103	1.23:1
HAMPDEN BANCORP MHC	$454,192	$234	0.21%	2.95%	$301,591	$8	$25	0.32:1
MESABA BANCSHARES	$453,661	$2,523	2.22%	27.47%	$418,529	$43	$100	0.43:1
CORTLAND BANCORP	$453,575	$1,183	1.04%	11.14%	$189,731	$63	$66	0.95:1
HOME STATE BANCORP	$452,821	$1,186	1.05%	12.43%	$333,110	$476	$175	2.72:1
WVS FINANCIAL CORP.	$452,788	$800	0.71%	11.60%	$56,763	$0	($39)	0.00:1
FIRST PULASKI NATIONAL	$452,554	$1,266	1.12%	11.61%	$274,903	$80	$20	4.00:1
CITIZENS NATIONAL BANCORP	$452,501	$1,898	1.68%	18.25%	$366,852	$21	$150	0.14:1
ALLIANCE BANCSHARES	$452,375	$846	0.75%	8.16%	$292,054	$175	$65	2.69:1

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MICRO HOLDING COMPANY	Total Assets (000)	Net Income, YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
PLANTERS HOLDING COMPANY	$477,076	$1,640	1.38%	15.41%	$277,999	$103	$127	0.81:1
WEST TENNESSEE BANCSHARES	$477,069	$1,190	1.00%	14.31%	$277,971	$131	$447	0.29:1
UNION NATIONAL FINANCIAL	$476,869	$922	0.77%	10.18%	$304,905	$21	$30	0.70:1
HERSHENHORN BAN	$476,623	$5,169	4.34%	25.06%	$318,508	$0	($272)	0.00:1
EAGLE FINANCIAL SERVICES	$475,123	$1,587	1.34%	15.75%	$361,270	$53	$75	0.71:1
INDEPENDENT SOU RN BANCSHARES ESOT	$474,783	$1,439	1.21%	12.70%	$352,659	$201	$215	0.93:1
CENTRAL VALLEY COMMUNITY BANCORP	$474,035	$1,570	1.32%	14.40%	$293,618	$572	$400	1.43:1
MID-MISSOURI BANCSHARES	$473,512	$1,008	0.85%	9.01%	$359,718	$100	$30	3.33:1
JEFF DAVIS BANCSHARES	$473,266	$1,447	1.22%	14.76%	$227,839	$139	$240	0.58:1
BANK OF EAST ASIA LIMITED	$472,358	$775	0.66%	4.36%	$394,580	$0	$0	n/a
RED RIVER BANCSHARES	$471,524	$1,268	1.08%	13.64%	$323,278	$86	$345	0.25:1
STEWARDSHIP FINANCIAL	$471,135	$1,187	1.01%	13.05%	$346,283	$0	$50	0.00:1
PLUMAS BANCORP	$470,533	$1,374	1.17%	13.92%	$323,687	$175	$300	0.58:1
NEIGHBOR INSURANCE AGENCY	$470,306	$1,460	1.24%	10.44%	$323,857	$8	$50	0.16:1
FARMERS STATE	$468,782	$1,681	1.43%	14.44%	$334,343	$10	$125	0.08:1
HABERSHAM BANCORP	$468,281	$1,470	1.26%	12.26%	$320,054	$65	$0	n/a
STARION BAN	$468,152	$1,949	1.67%	19.69%	$326,937	$64	$99	0.65:1
SUMITOMO TRUST & BANKING CO. LTD	$467,812	$3,671	3.14%	15.43%	$0	$0	$0	n/a
FNBH BANCORP	$467,806	$1,633	1.40%	13.10%	$371,820	$478	$600	0.80:1
BRYAN FAMILY MANAGEMENT TRUST	$466,979	$1,671	1.43%	14.52%	$304,235	$17	$135	0.13:1
BANCMIDWEST	$466,689	$2,012	1.72%	21.43%	$391,412	$175	$268	0.65:1
SOLVAY BANK CORP.	$465,355	$1,229	1.06%	11.19%	$326,972	$126	$126	1.00:1
FIRST COMMUNITY	$465,311	$860	0.74%	10.12%	$389,756	$102	$140	0.73:1

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MICRO HOLDING COMPANY	Benchmark Rating	P(D) (bp)	LGD %	M (yrs)	EAD %	Economic Capital	Tier 1 RBC	EC to Tier 1 RBC	RAROC %
PACIFIC FINANCIAL	AA	2.5	94.00%	2.49	23.50%	$13,131	$41,006	0.32	36.62%
MIDSTATE BANCORP	AAA	0.8	-16.70%	1.28	16.20%	$14,794	$45,916	0.322	33.51%
DNB FINANCIAL	A	4.2	86.00%	3.82	16.20%	$24,771	$40,143	0.617	16.68%
FARMERS ENTERPRISES	AAA	0.6	33.30%	2.91	20.90%	$3,822	$44,188	0.086	128.65%
PSB GROUP	A	5.6	63.00%	3.08	17.10%	$5,433	$39,654	0.137	81.56%
PLATTE VALLEY FINANCIAL	A	7.8	83.50%	2.83	20.50%	$11,609	$44,734	0.26	33.78%
PARAGON COMMERCIAL	AAA	0.4	100.00%	1.24	26.10%	$142	$40,066	0.004	3432.59%
SABINE BANCSHARES	A	6.2	85.30%	1.72	29.90%	$24,450	$33,497	0.73	20.56%
SECURITY NATIONAL	A	8.4	83.70%	2.02	26.80%	$9,246	$42,199	0.219	47.02%
BEACH COMMUNITY	AAA	0	n/a	0.77	17.20%	$1,064	$39,216	0.027	487.31%
FIRST NATIONAL	AA	1.5	-96.60%	3.08	17.20%	$1,248	$38,380	0.033	347.83%
CENTRAL BANk	AA	3.3	78.20%	0.74	39.00%	$9,248	$84,010	0.11	100.33%
SHINHAN FINANCIAL GROUP	AAA	0	n/a	0.67	8.80%	$35,634	$62,617	0.569	12.25%
MAGNOLIA BANKING	A	10.8	70.00%	2.31	25.50%	$16,260	$41,729	0.39	31.81%
SOU RN BANCORP INC	A	4.7	53.10%	2.11	24.30%	$13,977	$39,342	0.355	34.03%
STOCKMENS FINANCIAL	AA	2.2	-189.70%	2.01	24.00%	$14,364	$39,415	0.364	27.66%
HERITAGE OAKS BANCORP	AAA	0	n/a	3.1	36.80%	$1,072	$45,903	0.023	521.74%
PEOPLES BAN	AA	1.9	93.00%	1.6	28.10%	$12,466	$40,927	0.305	26.10%
NATIONAL BANCSHARES	BBB	20.7	-2.70%	2.63	12.30%	$7,637	$46,219	0.165	66.76%
NATIONAL MERCANTILE	AAA	0	n/a	1.47	30.40%	$36,191	$45,369	0.798	16.26%
FIDELITY COMPANY	AA	1.4	33.90%	2.99	14.80%	$3,207	$36,921	0.087	116.82%
INDEPENDENT HOLDINGS	A	12	54.50%	4.75	12.30%	$6,288	$47,249	0.133	38.69%
BLUE RIDGE BANCSHARES	A	8.6	64.70%	1.64	34.50%	$37,645	$42,289	0.89	8.90%
SOUTHCOAST FINANCIAL	AA	1.7	100.00%	2.59	12.60%	$1,189	$46,439	0.026	333.52%
MID ILLINOIS BANCORP	AAA	0.7	23.80%	6.95	16.80%	$2,676	$51,528	0.052	160.19%
NEXTIER INCORPORATED	AAA	0.5	-117.60%	3.86	38.90%	$1,981	$52,678	0.038	186.60%

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MICRO HOLDING COMPANY	Total Assets (000)	Net Income, YTD	ROA %	ROE %	Loans and Leases	Gross Losses	Loss Provisions	Provisions/ Defaults Ratio
CRETE BAN	$452,063	$1,025	0.91%	10.73%	$333,702	$0	$90	0.00:1
PRUDENTIAL MUTUAL HOLDING COMPANY	$450,635	$1,028	0.91%	6.12%	$194,957	$0	$0	n/a
SOUTHCREST FINANCIAL GROUP	$450,191	$1,515	1.35%	11.11%	$280,129	$102	$108	0.94:1
OCONOMOWOC BANCSHARES	$449,605	$1,111	0.99%	11.91%	$392,947	$55	$0	n/a
FRONT RANGE CAPITAL	$449,501	$540	0.48%	6.25%	$322,729	$239	$255	0.94:1
HAPPY BANCSHARES	$449,238	$1,065	0.95%	10.60%	$283,358	$55	$150	0.37:1
COMMUNITY WEST BANCSHARES	$448,710	$1,329	1.18%	13.38%	$386,881	$232	$183	1.27:1
EVANS BANCORP	$447,909	$893	0.80%	10.18%	$261,505	$159	$282	0.56:1
BLACKHAWK BANCORP	$447,552	$574	0.51%	6.06%	$274,358	$169	$93	1.82:1

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MICRO HOLDING COMPANY	Benchmark Rating	P(D) (bp)	LGD %	M (yrs)	EAD %	Economic Capital	Tier 1 RBC	EC to Tier 1 RBC	RAROC %
UNION NATIONAL FINANCIAL	AAA	0.7	-114.30%	4.9	39.30%	$25,964	$36,743	0.707	14.26%
HERSHENHORN BAN	AAA	0	n/a	0.27	11.50%	$57,831	$82,539	0.701	12.36%
EAGLE FINANCIAL SERVICES	AA	1.5	32.10%	3.21	26.00%	$26,667	$40,757	0.654	16.02%
INDEPENDENT SOU RN BANCSHARES ESOT	A	5.7	28.40%	1.72	19.10%	$4,039	$46,230	0.087	112.22%
CENTRAL VALLEY COMMUNITY BANCORP	BBB	19.5	95.10%	1.95	47.70%	$6,705	$34,106	0.197	81.18%
MID-MISSOURI BANCSHARES	AA	2.8	80.00%	1.36	15.40%	$3,057	$39,560	0.077	108.31%
JEFF DAVIS BANCSHARES	A	6.1	74.10%	2.46	15.50%	$1,686	$38,207	0.044	260.35%
BANK OF EAST ASIA LIMITED	AAA	0	n/a	1.92	16.70%	$14,513	$58,012	0.25	30.02%
RED RIVER BANCSHARES	AA	2.7	47.70%	3.25	18.60%	$19,532	$38,229	0.511	20.51%
STEWARDSHIP FINANCIAL	AAA	0	n/a	7.57	35.00%	$34,054	$37,184	0.916	12.24%
PLUMAS BANCORP	A	5.4	68.00%	3.51	32.90%	$22,710	$39,103	0.581	23.45%
NEIGHBOR INSURANCE AGENCY	AAA	0.2	-137.50%	2.54	27.30%	$1,956	$57,078	0.034	220.38%
FARMERS STATE	AAA	0.3	50.00%	1.65	20.50%	$4,856	$37,097	0.131	89.92%
HABERSHAM BANCORP	AA	2	7.70%	0.63	28.00%	$6,486	$44,838	0.145	74.16%
STARION BAN	AA	2	95.30%	4.03	16.90%	$1,830	$40,770	0.045	258.76%
SUMITOMO TRUST & BANKING CO. LTD	AAA	0	n/a	0	n/a	$65	$95,574	0.001	- 4601.85%
FNBH BANCORP	BBB	12.9	76.60%	2.12	18.70%	$20,431	$50,530	0.404	24.27%
BRYAN FAMILY MANAGEMENT TRUST	AAA	0.6	58.80%	3.48	8.60%	$29,549	$45,541	0.649	15.40%
BANCMIDWEST	A	4.5	51.40%	1.62	18.40%	$7,184	$36,286	0.198	61.75%
SOLVAY BANK CORP.	AA	3.9	73.00%	8.19	19.10%	$22,812	$44,631	0.511	17.96%
FIRST COMMUNITY BANCSHARES	AA	2.6	89.20%	2.34	14.70%	$1,161	$33,894	0.034	314.09%
INDUSTRY BANCSHARES	BBB	18.7	98.40%	3.88	14.80%	$2,356	$37,637	0.063	194.00%
HOMESTAR FINANCIAL GROUP	AAA	0.3	60.00%	6.42	14.80%	$10,037	$32,031	0.313	32.09%

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MICRO HOLDING COMPANY	Benchmark Rating	P(D) (bp)	LGD %	M (yrs)	EAD %	Economic Capital	Tier 1 RBC	EC to Tier 1 RBC	RAROC %
FIRST COMMUNITY	AA	2	33.30%	1.97	17.50%	$62,657	$37,238	1.683	7.15%
CAPITAL BANCORP	AA	1.9	85.70%	1.94	26.10%	$2,898	$38,335	0.076	150.04%
CITIZENS BANCSHARES OF BATESVILLE	BBB	19.1	79.50%	3.8	3.40%	$2,700	$41,602	0.065	145.48%
BANKERS' BANCORP	AAA	0.1	100.00%	1.43	34.70%	$91,766	$39,143	2.344	4.89%
CODORUS VALLEY BANCORP	AAA	0.2	-214.30%	4.1	30.10%	$8,227	$38,240	0.215	53.81%
COMMUNITY CENTRAL BANK	AA	1.1	89.50%	2.71	24.20%	$7,050	$42,345	0.166	50.61%
PULASKI INVESTMENT	AA	3.2	92.10%	2.72	32.50%	$2,644	$38,318	0.069	120.38%
WHITCORP FINANCIAL COMPANY	AA	3.4	-102.70%	1.38	23.10%	$16,046	$50,448	0.318	35.73%
BCB BANCORP	AA	2.1	100.00%	9.05	10.70%	$135,994	$49,135	2.768	4.09%
BRANNEN BANKS OF FLORIDA	AAA	0.1	-2800.00%	10.13	20.10%	$3,479	$29,664	0.117	128.50%
OXFORD FINANCIAL	AAA	0.2	66.70%	2.72	36.50%	$2,743	$42,387	0.065	174.22%
CONNECTICUT MUTUAL HOLDING COMPANY	AAA	0.2	0.00%	9.73	18.20%	$60,466	$44,294	1.365	7.32%
FIRST FARMERS FINANCIAL	A	4.7	93.00%	1.75	20.80%	$41,723	$47,888	0.871	11.55%
COMMUNITY BANC-CORP OF SHEBOYGAN	BBB	13	96.80%	1.46	29.70%	$11,249	$38,766	0.29	30.38%
FCB BANCORP	AAA	0	n/a	1.86	21.40%	$4,041	$40,724	0.099	126.57%
1ST CENTENNIAL BANCORP	AA	3	-5.90%	2.43	54.20%	$1,805	$47,772	0.038	321.29%
GUARANTY FEDERAL BANCSHARES	AAA	0.7	18.80%	5.8	20.30%	$1,955	$55,216	0.035	212.29%
COMMERCIAL HOLDING COMPANY	AA	2.4	-7.90%	1.99	40.40%	$2,878	$37,717	0.076	149.70%
S.B.C.P. BANCORP	AA	1.3	79.20%	1.96	26.50%	$29,978	$39,544	0.758	12.85%
FAUQUIER BANKSHARES	AA	1.8	52.70%	6.25	29.10%	$7,116	$40,713	0.175	54.71%
PLANTERS HOLDING COMPANY	AA	3.7	79.60%	2.11	17.20%	$10,870	$43,810	0.248	41.27%
WEST TENNESSEE BANCSHARES	A	4.7	79.40%	1.85	37.50%	$3,733	$35,047	0.107	107.69%

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MICRO HOLDING COMPANY	Benchmark Rating	P(D) (bp)	LGD %	M (yrs)	EAD %	Economic Capital	Tier 1 RBC	EC to Tier 1 RBC	RAROC %
WEST POINTE BANCORP	AA	4	66.00%	1.5	22.00%	$2,324	$36,307	0.064	173.76%
INTER-MOUNTAIN BANCORP.	AAA	0.1	0.00%	1.69	31.60%	$27,623	$37,611	0.734	18.93%
PUTNAM-GREENE FINANCIAL	AA	2.6	-26.30%	1.24	9.40%	$9,803	$42,760	0.229	55.62%
INTERNATIONAL BRO RHOOD OF BOILERMAKERS IRON SHIP BUILDERS BLACKSMITHS FORG	AA	2.9	62.30%	4.58	33.40%	$6,361	$41,596	0.153	79.18%
PUTNAM BANCSHARES	A	9.6	44.50%	8.16	10.00%	$43,504	$58,868	0.739	10.51%
FIRST LITCHFIELD FINANCIAL	AAA	0.1	-150.00%	8.51	32.40%	$9,231	$32,619	0.283	46.39%
PALOS BANCSHARES	AA	1.3	93.50%	2.02	59.70%	$36,775	$38,545	0.954	14.50%
AMERICAN COMMUNITY BANCSHARES	AA	2.2	98.70%	1.5	22.20%	$4,533	$37,631	0.12	92.99%
ST. JOSEPH CAPITAL	AAA	0	n/a	3.34	30.20%	$0	$36,368	0	0.00%
WEST ALABAMA CAPITAL CORP.	A	7.2	67.00%	2.85	2.20%	$7,409	$43,716	0.169	60.91%
CROGHAN BANCSHARES	A	4.9	73.90%	3.66	23.20%	$2,987	$36,680	0.081	143.66%
B.P.C.	A	5.3	74.00%	3.6	13.80%	$9,749	$32,495	0.3	36.95%
HAMPDEN BANCORP MHC	AAA	0.3	50.00%	5.3	17.60%	$32,217	$33,487	0.962	10.18%
MESABA BANCSHARES	AA	1	9.30%	1.92	19.20%	$8,521	$36,912	0.231	51.30%
CORTLAND BANCORP	AA	3.3	50.80%	5.23	25.70%	$138,996	$43,554	3.191	4.16%
HOME STATE BANCORP	BBB	14.3	96.00%	3.64	22.90%	$484	$39,439	0.012	822.79%
WVS FINANCIAL CORP.	AAA	0	n/a	7.1	34.10%	$341,194	$27,532	12.393	1.91%
FIRST PULASKI NATIONAL	AA	2.9	-31.30%	1.74	15.30%	$11,371	$45,003	0.253	38.36%
CITIZENS NATIONAL BANCORP	AAA	0.6	-323.80%	1.93	18.10%	$2,193	$41,815	0.052	182.85%
ALLIANCE BANCSHARES	A	6	66.90%	8.39	15.20%	$21,744	$37,677	0.577	15.41%
CRETE BAN	AAA	0	n/a	3.06	35.30%	$4,097	$38,759	0.106	88.05%
PRUDENTIAL MUTUAL HOLDING COMPANY	AAA	0	n/a	10.36	28.70%	$207,510	$66,905	3.102	2.59%

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SOUTHCREST FINANCIAL GROUP	AA	3.6	-39.20%	3.86	14.20%	$72,047	$48,378	1.489	7.01%
OCONOMOWOC BANCSHARES	AA	1.4	76.40%	1.69	17.50%	$1,605	$37,412	0.043	227.95%
FRONT RANGE CAPITAL	A	7.4	91.60%	1.84	21.90%	$5,183	$35,621	0.146	70.71%
HAPPY BANCSHARES	AA	1.9	25.50%	2.6	28.20%	$3,203	$34,388	0.093	128.96%
COMMUNITY WEST BANCSHARES	A	6	98.30%	4.86	15.10%	$34,012	$39,644	0.858	14.88%
EVANS BANCORP	A	6.1	81.10%	4.67	26.60%	$5,145	$35,642	0.144	82.33%
BLACKHAWK BANCORP	A	6.2	74.60%	3.15	18.10%	$12,893	$32,618	0.395	26.25%

For more information, please contact us:

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September 13, 2006

The Honorable Spencer C. Bachus
Chairman, Subcommittee on Financial Institutions and Consumer Credit
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515-6051

Re: A Review of Regulatory Proposals on Basel Capital
and Commercial Real Estate

Dear Mr. Chairman:

The Real Estate Roundtable (www.rer.org) is pleased to provide comments in conjunction with the Subcommittee on Financial Institutions and Consumer Credit September 14, 2006 hearing on *A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate*. We would like to commend the Committee for their work toward examining the regulatory proposals on the New Basel Capital Accord ("the New Accord") and the proposed guidance on "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" ("the Guidance").

The Real Estate Roundtable supports the efforts of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, "the Agencies") to ensure the safety and soundness of the banking system and, in particular the stability of the commercial real estate markets. We also support efforts to more closely align regulatory capital with economic capital and implement a more consistent conceptual risk capital framework in our global financial services system through the New Accord.

However, we also have serious concerns about ensuring that these measures do not result in any significant unintended consequences — both for the commercial real estate sector and the overall economy. The Roundtable urges the Agencies, and this Committee, to monitor closely the manner in which the Guidance and the New Accord are applied and administered throughout the United States in order to ensure that no unintended and destabilizing consequences occur in any individual local markets that might undermine their goal of ensuring continued economically sound lending.

The Real Estate Roundtable and its members lead an industry that generates more than 20 percent of America's gross national product, employs more than 9 million people, and produces nearly two-thirds of the taxes raised by local governments for essential public services. Our members are senior real estate industry executives from the U.S.'s leading income-producing real property owners, managers and investors; the elected heads of America's leading real estate trade organizations; as well as the key executives of the major financial services companies involved in financing, securitizing, or investing in income-producing properties.

1420 New York Avenue, N.W. • Suite 1100 • Washington, DC 20005 • Phone: 202-639-8400 • Fax: 202-639-8442 • www.rer.org

The Real Estate Roundtable strongly supports the Agencies' efforts to promote economically responsible commercial real estate lending that reflects sound underwriting and risk management practices. In this regard, the Roundtable firmly believes that banks should not be treated punitively for making sensibly underwritten acquisition, development, and construction loans. But we also share the Agencies' concern that rapid growth in the commercial real estate portfolios of certain institutions, and attendant weaknesses in control and reporting practices, may have resulted in some uneconomic lending that could threaten both the safety and soundness of the institutions involved and the proper functioning of the commercial real estate market. Thus, the Roundtable does not advocate regulatory policy that allows uneconomic lending on real property that is not appropriately collateralized or not supported by adequate pre-sales or pre-leasing.

Rather, we support regulatory policy that encourages sound lending standards by which real estate loans are sensibly underwritten, economic risk is rationally priced, and loans are appropriately collateralized with substantial equity and/or adequate presales or pre-leasing. Within this context, we believe that the proposed Guidance constitutes a prudent step to ensure that the commercial real estate lending market continues to function with the appropriate level of discipline.

The risk management principles and capital adequacy guidelines outlined in the Guidance appear to reflect best practices to which all U.S. depository institutions are already expected to adhere in connection with their commercial real estate lending activities. It is therefore our understanding that the Guidance does not impose new requirements on institutions found to be heavily concentrated in commercial real estate lending. Rather, the Guidance reiterates existing requirements applicable to all financial institutions and calls on identified institutions and their examiners to pay special attention to such requirements as they apply to the institutions' real estate loan portfolios.

Bank underwriting standards have improved since the last economic cycle, resulting in more realistic loan-to-value requirements, more accurate estimates of future cash flows, and more proactive management of non-performing assets. In addition, federal regulatory agencies have provided stronger regulatory oversight of the sector. Real estate's increasing role in global capital markets – through securitization vehicles such as commercial mortgage backed securities (CMBS) and real estate investment trusts (REITs) — has led to greater transparency, enhanced liquidity, better discipline and more exacting scrutiny of commercial real estate asset quality. As a result, the process for disclosing market information has become more defined, the quality of information required by both regulators and investors has improved, and the speed with which property performance information is available has accelerated.

Although the Real Estate Roundtable does not have an objection to the Guidance itself in its present form, we believe the Agencies should take appropriate steps to actively monitor the application and administration of the Guidance by their supervisory personnel throughout the country. As the Agencies are well aware, overzealous or inconsistent application and enforcement of the Guidance could lead to unintended consequences for the commercial real estate market and, in turn, for those depository institutions the Guidance is meant to protect.

Commercial Banks Vital to Real Estate Credit Availability

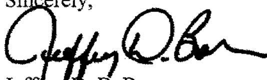
Commercial banks constitute one of our nation's largest source of commercial and multifamily real estate financing. A sudden and significant contraction of bank credit available for commercial real estate could lead to a decline in property values and in the economic condition of existing borrowers. Such a decline would, in turn, reduce the quality of outstanding loans and thus threaten the health of banks that are significantly concentrated in commercial real estate, which would likely lead such banks to further curtail credit. Unfortunately, we have experienced such vicious cycles in the past and seen the consequences for our economy as a whole. This experience underscores the importance of ensuring that the Guidance is applied and administered with care; otherwise, the Guidance can become a self-fulfilling prophecy, inducing the very same consequences it seeks to prevent. It is also important for the Committee to ensure that the any new capital standards for commercial real estate established by the New Accord do not unsettle, or substantially disrupt, real estate credit.

The U.S. commercial real estate market has proven to be strong and a key driver of our economy. Accordingly, it is vital that the Agencies appropriately monitor the application and administration of the Guidance to ensure that such application and administration is balanced, consistent and otherwise conforms to the Agencies' intentions. As one element of such monitoring, the Roundtable respectfully suggests that the Agencies sponsor periodic industry forums. These forums would permit institutions, their customers, and other interested parties to provide feedback to the Agencies on the implementation of the Guidance in the field. Such forums, held on a quarterly or semiannual basis, could serve as an early warning system to alert the Agencies regarding potential issues with respect to the administration and implementation of the Guidance. This feedback would allow the Agencies to address appropriately any possible overreaction to the Guidance by supervisory personnel or by the institutions they supervise that might threaten the soundness of the banking system or the stability of the real estate lending market on which such soundness depends in significant part.

We trust the Committee may find our comments useful. Should you have questions or require additional information, please contact Clifton E. Rodgers, Jr. by telephone at (202) 639-8400 or by email at crodgers@rer.org.

Thank for this opportunity to comment on this important issue.

Sincerely,



Jeffrey D. DeBoer
President and Chief Executive Officer

Statement of the

The Risk Management Association

Submitted to the

Subcommittee on Financial Institutions and Consumer Credit

Financial Services Committee

of the

U.S. House of Representatives

September 14, 2006

The Risk Management Association is a member-driven professional association whose objective is to further the ability of our members to identify, assess and manage the impacts of credit risk, operational risk and market risk on their businesses and customers. While RMA was not invited to submit testimony to the Subcommittee for its September 14, 2006 hearing entitled, "A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate" RMA hereby submits this statement in support of a truly risk-based capital regime in which capital requirements are linked to risk. RMA has a tremendous depth of experience in the development of the revised Capital Accord. In 1999, RMA established the Capital Working Group[1] to provide industry input into the Basel Reform Process. As a result, RMA has been engaged in many direct discussions with regulators, submitted commentary on both Basel and U.S. proposals, performed surveys and analyses of U.S. bank practices, and otherwise devoted considerable time and energy to this work. Many of our members have likewise invested in the process of improving capital regulation.

RMA's membership includes some banks that would be required to operate under the U.S. version of the Basel rules; others that are working toward qualifying for this treatment as opt-in institutions; and still others that would operate under the general capital rules in the U.S. We have long supported the goals regulators set out when they began updating the Basel rules.

[1] The RMA Capital Working Group consists of senior risk management officers at large banking organizations responsible for the measurement of risk and the determination of Economic Capital. Institutions represented include: ABNAMRO North American, Bank of America, Capital One, Citigroup, Comerica, Countrywide Financial Corp., HSBC/North American Holdings, JPMorganChase & Co., KeyCorp, M and T Bank, RBC Financial, State Street, SunTrust, Union Bank of California, U.S. Bancorp, Wachovia, Washington Mutual Bank, and Wells Fargo.

Today's capital rules are based in large part on the 1988 version of the Basel Accord. The reforms currently being proposed for the domestic industry are intended, at least in part, to align U.S. rules with the most recent Basel standards. This effort has been underway for a decade, and both U.S. and international regulators have engaged in a productive dialogue to tap into the best thinking on this subject by the industry and academia.

Bank regulations seek to simultaneously accomplish multiple objectives. Two of them are particularly relevant to a discussion of capital standards. First, regulations work to ensure the safety and soundness of the banking system and individual institutions. Second, they must enable banks to attract the capital needed for a healthy system by permitting banks to earn an adequate return on that capital.

Safety and soundness is largely a matter of being able to absorb the losses that occur in an uncertain world. The first line of protection against losses is ongoing profit; in nearly all cases individual loan losses simply mean smaller profits, not a net loss at the firm level. An adequately capitalized bank will have sufficient capital to absorb losses in those periods where actual losses occur. Safety can be enhanced in two equally effective ways – banks can take less risk and reduce the possibility of experiencing a loss, or they can hold more capital.

Holding more capital means that profits will be divided over a larger base, lowering the return on each dollar of capital. Requiring excessive capital levels makes it difficult for banks to earn an adequate return on that capital, with the risk that investors will move their capital to other industries or countries.

When the reform process began more than seven years ago, it was widely agreed that the 1988 Basel Capital Accord had taken only one step toward the objective of safety and soundness. At a minimum, it required that banks hold 8% capital for all corporate exposures (4% for mortgages), regardless of their relative risk. A high-risk bank needed no more capital than a bank with very low risk assets.

Absent rules requiring more capital for more risk, regulators wanted ample capital in *all* cases. Banks found it difficult to earn an appropriate return on the disproportionate capital required for low-risk exposures and consequently moved these exposures off their balance sheets or otherwise structured risks so that they did not require as much capital under these rules. These were not signs of a good rule.

Basel II was designed to align capital requirements with risk, ensuring that high-risk institutions were covered with adequate capital while enabling lenders to earn appropriate returns for low-risk business. U.S. regulators have clearly taken a leading role in the development of the new international framework and the formulas that set the minimum capital requirements.

Importantly, these new rules rely not only on the computed capital requirement, but also on two complementary elements, described as the second and third pillars of the Accord. Supervisory Review – long a key strength of the U.S. regulatory system – was introduced to provide assurance that banks are appropriately fulfilling their responsibilities under the new rules and to address risks that are not explicitly captured in Pillar I. The third pillar, enhanced disclosure, builds on a trend toward greater transparency.

The international Accord offers banks choices about the level of complexity they will adopt. For credit risk, the Standardized Approach is somewhat more risk sensitive than Basel I and requires only basic risk information. More complex information, including risk measurements developed from internal performance results, is required for the Foundation and Advanced Internal-Ratings Based Approaches. Developing these internal results so as to meet the demanding validation requirements of the Accord is very costly, but the rules are designed to build on the systems nearly all internationally-active banks have already built for their own risk management purposes. In fact, the *use test* is an important principle in the Accord, encouraging banks to improve their risk management quantifications and to use the results in the capital computations. Banks are spending hundreds of millions of dollars on systems that will be used for Basel, and duplicative spending on both internal systems and similar but different compliance systems would be an enormous and unnecessary cost burden.

The Basel Committee carefully calibrated the three approaches for credit risk in order to satisfy two criteria. First, the calibration enhances safety and soundness. The Standardized Approach generally requires higher capital levels than the Foundation IRB Approach, while the Advanced IRB Approach tends to require the least. This means that capital requirements are normally higher for those banks whose risks are not as well quantified, and lower in those cases where we best know the risk. But specific requirements put capital where it's needed: advanced IRB banks that have high-risk portfolios require more capital than under the other approaches.

Second, the calibration encourages banks to invest in the expensive developments needed to qualify for the advanced approaches. While it is true that there are many

business benefits for understanding risk better, most banks have already captured these in their internal systems. Still, there is clearly a large incremental cost to make internal systems suitable for Basel purposes. By allowing a better alignment of capital with risk, the international calibration permits advanced banks to put their capital to work more efficiently, justifying their large investments. Without this intentional calibration, banks would quite reasonably elect to avoid massive compliance costs and operate under the standardized approach, revealing less about their risk and the adequacy of their capital.

The U.S. and foreign regulators forming the Basel Committee adopted the Accord in June 2004, with an update following in late 2005 to address some residual issues. For banks using the Advanced approach, the Accord calls for a year of parallel operation in 2007. The new rules are to be used to set minimum capital levels beginning in 2008, although there are floors through the transition years of 2008 and 2009.

The Accord is not itself a rule. It is an agreement that must be put into effect through each country's legislative or rulemaking process. In much of the world – notably Europe and Canada – the Accord has been adopted largely along the lines agreed to in Basel. Banks in these areas will see their capital requirements aligned with their risks beginning in 2008, and some of our member banks report that they are already seeing an increased willingness of international lenders to price longer-term low-risk deals to reflect lower capital requirements.

Unfortunately, the U.S. situation is quite different. While other nations – and their banks, which compete with U.S. institutions – move ahead with this new, risk-sensitive regime, the U.S. process is mired in uncertainty and at risk of producing a rule that fails to deliver on the Basel objectives.

The U.S. regulatory implementation plans have for some time differed significantly from the framework agreed to in Basel. In 2003, the U.S. agencies announced through an ANPR that instead of offering several approaches with varying degrees of complexity, they would offer only the advanced approaches from the Accord, with large banks mandated to use the new rules and other banks permitted to opt in to them. Remaining banks would continue under the general capital rules. In late 2005, they proposed new general capital rules for non-Basel banks. The smallest banks would be allowed to remain on the old rules derived from the 1988 Basel Accord. The intent of these revisions was to make the general capital rules more risk sensitive, lessening the difference between the capital computed under the Basel rules and the general capital rules. The proposed new general capital rules, often called Basel 1A, used many of the risk sensitive concepts from the Basel Standardized Approach, but there were numerous differences and many open-ended questions that left the final form of the rule unclear. While the Basel Committee has conducted several quantitative impact studies to calibrate the approaches against each other, no such comparison has yet been done in the U.S., and RMA and its members are not able to estimate with much confidence how capital levels would compare among the alternatives, since there were so many unanswered questions in the 1A ANPR.

A year ago, U.S. regulators announced an additional delay around the Basel rules, and extended the implementation timeline with more conservative floors than provided in the Accord. Recently, the agencies adopted an NPR for Basel II that should be published in the Federal Register shortly. The NPR for the so-called Basel 1A has yet to be approved, calling into question the feasibility of hitting even the delayed implementation

date and forcing banks to proceed with their efforts without promised guidance from the agencies.

More disturbing to banks that must adopt the rule, the NPR reveals a variety of disappointing changes that back away from the risk sensitivity agreed to in Basel, that create competitive problems for American banks, and that increase the compliance burden they face.

It appears evident that the U.S. banking regulators are reluctant to acknowledge that safety and soundness can be improved by low risk as well as by high capital. Documents released to date lead banks to conclude that U.S. rules will require more capital for the same risk than those adopted elsewhere. Further, a new test has been introduced in the NPR that points to an even more conservative *re*calibration if capital requirements fall appreciably. This trigger is stated without regard to economic conditions, even though a risk-sensitive framework in a cyclical economy will without doubt produce requirements that fall and rise with business conditions. Severely limiting the *potential* capital reduction in the best part of the cycle is equivalent to *raising* capital requirements, since banks will want to have on hand the capital needed for the next downturn. In fact, Pillar II requires banks to have sufficient capital to handle the cyclical downturns that occur from time to time, so that it is redundant to include it in the Pillar I computation.

U.S. banks also face a second capital requirement not found in Europe or most other Basel countries. Our leverage ratio requirement is not at all risk sensitive. As described above, it makes sense for capital requirements to be higher for banks whose risks are not as well understood. The leverage ratio does not *seek* to understand risk, and

naturally requires lots of capital to ensure sufficient coverage without knowing how much risk a bank faces. It is not surprising, therefore, that the leverage ratio requirement is higher than the risk-based requirement for most institutions. While the Accord recognizes that greater safety can be achieved both by taking less risk and by reducing risk, U.S. rules look only to the latter. A bank must hold capital appropriate for higher risk even if it chooses to take less risk. This requirement for disproportionate capital levels has several negative consequences, which will be discussed in a moment.

First, however, we offer several comments about the 2004 Quantitative Impact Study, the results of which caused considerable concern among U.S. regulators and apparently led to the change in direction that the industry finds troubling. It is important to realize that the QIS provided a far-from-perfect preview of capital requirements under the Basel rules. Although one could see that lower risk portfolios tended to get lower capital levels, some results were inconsistent from bank to bank, which was not surprising, given that banks were only partially through their implementation efforts and regulatory guidance was incomplete, at best. It seems clear that some low numbers will increase to look more like those submitted by other banks, with the result that the overall change in capital is a smaller decrease than shown in the study.

Further, the QIS was performed at the very best part of the credit cycle. Several of our member banks have shared with regulators their analyses showing that capital requirements will be significantly higher in a period such as the 2000-2001 recession than reported in the QIS. Actual capital levels are unlikely to decline as much as minimum requirements in very favorable years, both because the Accord requires banks to have on

hand the capital needed for anticipated future downturns and because banks will not want to raise new capital in a recession.

The QIS results from some institutions may also be misleading because the risks *not* covered by the Pillar I formulas are not necessarily proportional to those that are covered. For example, mortgages tend to generate very low credit risk capital charges because of their low loss rates, but holding mortgages often entails interest rate and other risks that are larger – in proportion to credit risk – than for other loans. The capital rules have mechanisms under Pillar II to ensure that any institution with a significantly above-average proportion of their risks in an area like this would hold appropriate capital to cover such risks; their capital will not be permitted to decline as much as might be indicated by their QIS results. Some members report that their supervisors have already begun discussions toward resolving these issues. For most institutions, however, these risks will be covered by the calibration of the credit risk capital charge.

Among the most serious consequences of the U.S. mandate for high capital levels is that it puts U.S. banks in a difficult competitive position. Investors seek a higher return on capital than is required for funding from liabilities. Assets funded with more capital must be priced higher than those funded with less capital to earn an acceptable return. Banks operating under risk-sensitive capital requirements can better compete for low-risk loans than institutions that must hold extra capital. The disparity is greatest for assets that have the least risk. U.S. banks will have to forgo such business, or counterbalance low-risk business by taking on more high-risk loans to keep risk-based capital requirements about as high as the non-risk-based requirements. A regime that associates safety and soundness exclusively with high capital rather than low risk will push banks away from

low-risk strategies, since that approach will require disproportionate amounts of capital, lowering the return earned on each dollar of capital. It is inappropriate that regulations would discourage U.S. banks from adopting a low-risk approach to their business.

The NPR's conservatism plays out in another damaging way. The new Accord was presented as building on the systems banks have already put in place. The very name "Advanced Internal-Ratings Based Approach" signals that it is to use the *banks'* systems. A prime benefit of this approach is that the regulatory systems will improve as banks get smarter. Basel requires that banks capture lots of information and analyze it, which will clearly lead to an improved understanding of risk.

Unfortunately, the NPR contains so many conservative, prescriptive requirements for the methodologies used to generate the inputs to the capital formulas that banks will commonly be unable to use their own processes. Redundant systems, with no use save compliance, must be built at great cost. The Basel rules establish rigorous validation requirements, but U.S. regulators appear unwilling to trust these processes, even though they will oversee them. Instead, it appears that when in doubt, regulators have frequently written very conservative assumptions into the rules. With this approach, the U.S. regulatory system will be stuck in time using today's practices – or in some cases practices that even today are no longer standard – as opposed to best practices. The gap between bank internal risk measurement systems and the Basel II compliance system will grow as time passes. Banks will have to keep up with new developments, but it is unclear that a narrowly defined regulatory system can remain current.

The excuse for imposing detailed methodologies where banks already have internal processes is that uniform approaches are needed in order to make comparisons

from bank to bank. RMA is concerned that regulators expect all banks to have the same view of each risk, even though it is altogether reasonable that banks should often have *different* assessments of risk – this is why some banks make certain loans and other banks make other loans.

RMA expects that bank-to-bank comparisons will improve as the industry gains additional experience benchmarking their internal data as part of the validation requirements. The industry and RMA are already working toward this objective, even before regulators take the next steps. Our Capital Working Group is preparing right now to update a benchmarking survey for retail loans. We have found it quite possible to make such comparisons without mandating that everyone use a single methodology, underscoring the need for the capital rules to be principles-based rather than prescriptive.

Even as prescriptive rules have increased compliance costs, the burden has been exacerbated by the uncertainty and delay in the rulemaking. In many key areas the agencies have yet to provide guidance, and in others the draft rules indicate that guidance will change. Nevertheless, the documents are hung up in the morass of the interagency rulemaking process. Meanwhile, U.S. banks are expected to proceed with multi-million dollar implementation efforts. How much of this work, they wonder, will have to be thrown away when the real rules are finally disclosed?

To conclude, the RMA and our members support the objectives behind the Basel rules, and we strongly desire a risk-based capital framework for the U.S. We continue to support adoption of an advanced approach that is equivalent to what is being implemented in the rest of the world, and we believe it should offer advantages such that

banks elect to use it rather than being forced to use it. We support revising the rules for non-Basel banks to be more risk sensitive, too, with options that are matched to the size and complexity of these institutions. All of these approaches must be designed such that the burden of implementation is reasonable and appropriate. They must also be calibrated to work together to provide a safe and sound banking system while enabling banks to attract the capital needed for a healthy system by permitting them to earn an adequate return on that capital. Finally, and most importantly, the new capital standards must be set to evolve over time as additional advances in risk management practices within the industry take place.

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision

June 9, 2006

The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Congressman:

We are responding to your March 20, 2006, letter concerning the proposed interagency guidance on Commercial Real Estate (CRE) Concentrations. The enclosure to this letter contains the specific data you requested.

CRE concentrations have been rising over the past dozen years and are at record levels at many banking organizations. To some extent, this shift reflects changes in the demand for credit within certain geographic areas and the movement by many banking organizations to specialize in a lending sector that is perceived to offer enhanced earnings.

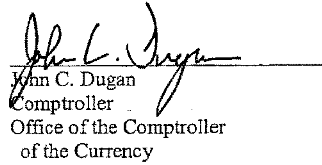
The agencies are concerned about CRE concentrations because of the potential volatility of the asset class and because of the central role CRE concentrations played in the banking problems of the late 1980s and early 1990s.

The intent of the proposed guidance is not to diminish the vital role that community banks and thrifts play in providing credit for business and real estate development. Importantly, the proposed guidance does not place any limits on the amount of commercial real estate lending that a bank or thrift may conduct. Rather, it reminds institutions that there are substantial risks posed by a credit concentration and that these risks should be recognized and appropriately addressed.

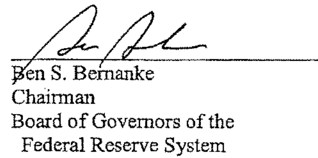
We believe that sound risk management practices are essential for a bank or thrift that has strategically decided to concentrate in CRE lending. In fact, the majority of the proposed guidance reinforces existing guidelines that have been in place since 1993. We realize, however, that this proposal has generated considerable public interest and we will seriously consider all comments received.

We appreciate your interest in this matter and the opportunity to respond to your concerns. Please do not hesitate to contact us if you have any further questions.

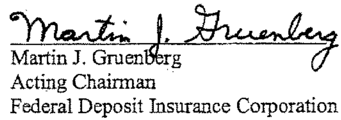
Sincerely,



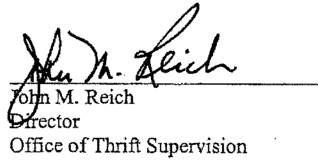
John C. Dugan
Comptroller
Office of the Comptroller
of the Currency



Ben S. Bernanke
Chairman
Board of Governors of the
Federal Reserve System



Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation



John M. Reich
Director
Office of Thrift Supervision

Enclosure

Response to Comments on
the Proposed Commercial Real Estate Concentration Guidance
Raised in the March 20, 2006, Letter from Congressman Frank to
the Federal Financial Institutions Regulatory Agencies

Comment: *In order to evaluate the need for the proposed guidance, I would like to know more about the data on which you are basing the guidance and whether there has been an upsurge in loan losses or deterioration in commercial real estate loan portfolios.*

Response: The agencies developed the proposed commercial real estate (CRE) concentration guidance based on our supervisory experience, an analysis of trends in CRE concentrations at banks and thrifts, and a review of industry benchmarks for assessing concentration risk. By proposing the guidance, the agencies are seeking the industry's comments on the appropriateness of the proposed guidance.

The following charts provide the historical trend in average concentration levels for all commercial and savings banks and all thrifts by four asset size groupings, based on data from the Call Report and the Thrift Financial Report. Chart I (covering commercial and savings banks) and Chart II (covering thrifts) reflect concentration levels for loans secured by real estate for: (a) construction, land development, and other land loans; (b) multifamily residential properties; and (c) nonfarm nonresidential properties. [1] In the charts, the ratio is based on the total of these loans as a percentage of total equity plus reserves for loan and lease losses. [2]

Small to mid-size institutions have shown the most significant increase in CRE concentrations over the last decade. CRE concentration levels at banks are now significantly higher than during the real estate crisis of the late 1980s and early 1990s. Concentration levels at banks with assets between $100 million and $1 billion have nearly doubled from approximately 145 percent of total equity plus reserves in 1993 to 280 percent in 2005. CRE concentrations at banks with assets of $1 billion to $10 billion increased from approximately 120 percent in 1993 to approximately 230 percent in 2005. To some extent, this shift reflects changes in the demand for credit within certain geographic areas and the movement by many banking organizations to specialize in a lending sector that is perceived to offer enhanced returns. While 2005 CRE concentration levels for thrifts in the same asset groups are lower than levels observed during the past real estate crisis, concentration levels for some thrifts have been trending upwards since 1999, particularly for thrifts with assets between $100 million to $1 billion and $1 billion to $10 billion.

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[1] While CRE concentration data for commercial and savings banks are presented for periods from 1980 to 2005, because of reporting changes, analogous data for thrifts were not readily available prior to 1989.

[2] In the proposed guidance, a CRE concentration is measured as the ratio of total CRE loans to total risk-based capital. However, financial institutions did not begin reporting risk-based capital until 1992. In order to show CRE data prior to 1992, total equity plus reserves was used as a close proxy for risk-based capital.

Chart I
Trend in CRE Concentrations by Asset Size
All Commercial & Savings Banks
(Total CRE Loans / Total Equity + Reserves)

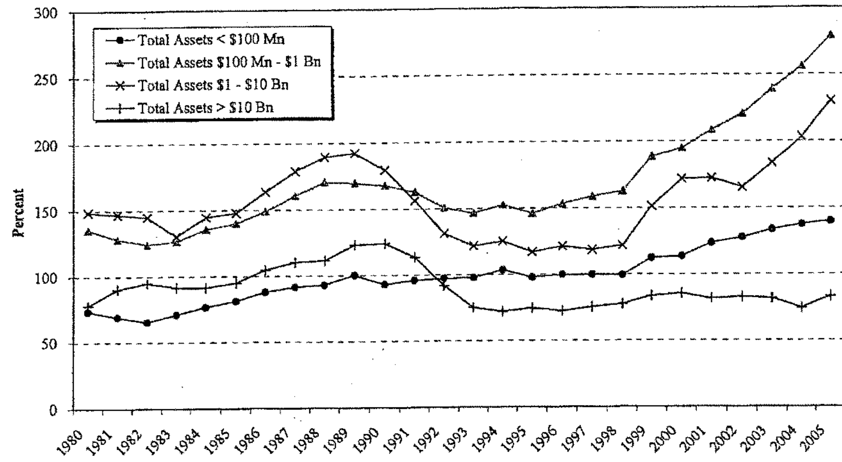


Chart II
Trend in CRE Concentrations by Asset Size
All Thrifts
(Total CRE Loans / Total Equity + Reserves)

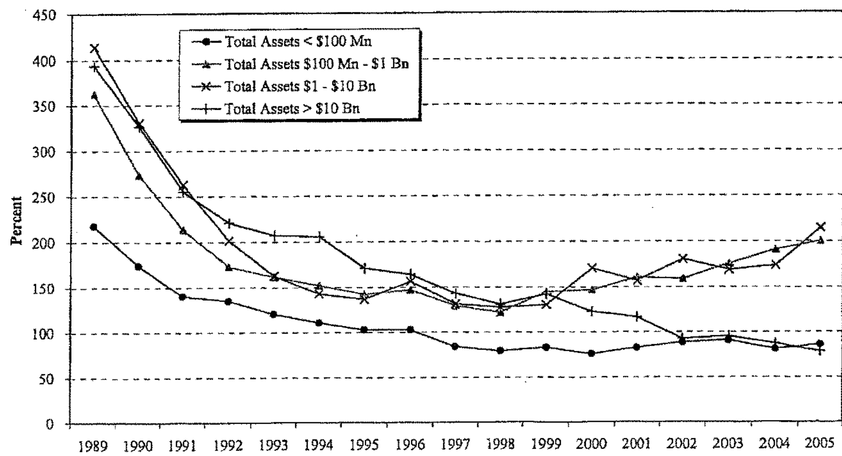


Chart III (covering commercial and savings banks) and Chart IV (covering thrifts) reflect trends in concentrations in construction loans at banks and thrifts. Chart III reflects a significant increase in concentrations of construction loans at commercial and savings banks over the last decade. This increase is particularly apparent in banks with assets between $100 million and $10 billion. On the other hand, as shown in Chart IV, concentrations in construction loans at thrifts have remained relatively stable since the early 1990s.

Chart III
Trend in Construction Concentrations by Asset Size
All Commercial & Savings Banks
(Total Construction Loans / Total Equity + Reserves)

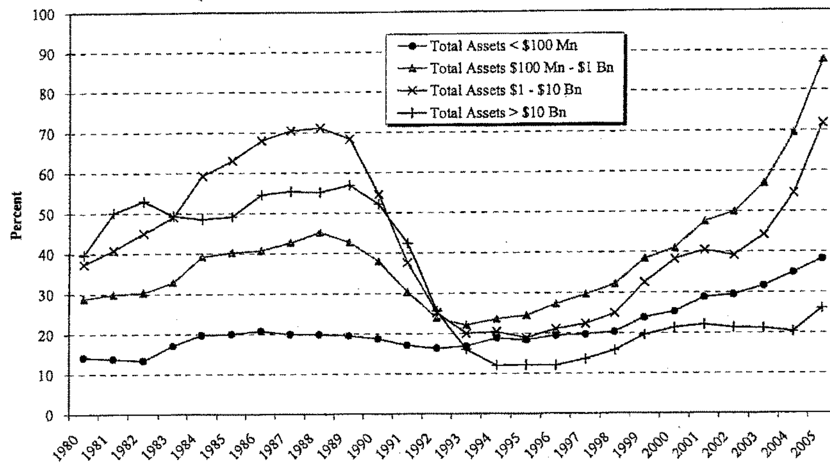
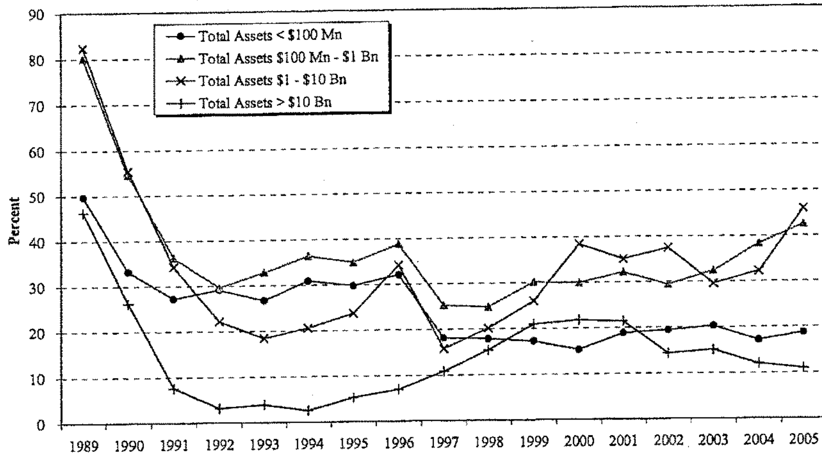


Chart IV
Trend in Construction Concentrations by Asset Size
All Thrifts
(Total Construction Loans / Total Equity + Reserves)

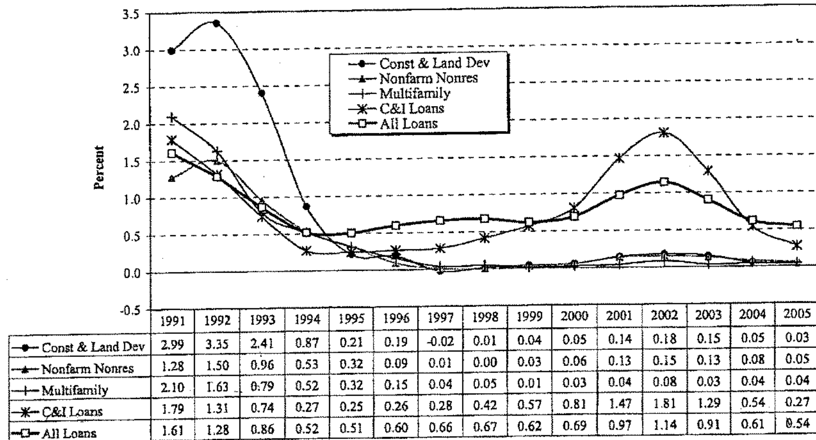


In recent examinations, examiners have observed that banks and thrifts have relaxed their underwriting standards as a result of strong competition for business. Further, examiners have also identified a number of institutions with high CRE concentrations that lack appropriate policies and procedures to manage the associated risk arising from a CRE concentration.

While CRE market fundamentals remain generally strong, and supply and demand are generally in balance, past history has demonstrated that these markets can experience fairly rapid changes. For banking organizations with significant concentrations, the ability to withstand difficult market conditions will depend heavily on how well developed their risk management processes are, and whether they are sufficiently capitalized.

In recent years, CRE portfolios have performed well, with charge-offs on CRE loans declining from a benign, but slightly elevated, level in 2002, as might be expected during this point in the credit cycle. Despite this relatively strong performance, the agencies believe that the proposed guidance will reinforce the importance of sound risk management practices that may minimize future credit losses. Chart V shows the net charge-off rate for the three principal types of CRE loans for all commercial banks since year-end 1991. For comparison purposes, the net charge-off rates for commercial and industrial (C&I) loans and all loans are also provided.

Chart V
Net Charge-off Rate by Loan Type
Commercial Banks Only



	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Const & Land Dev	2.99	3.35	2.41	0.87	0.21	0.19	-0.02	0.01	0.04	0.05	0.14	0.18	0.15	0.05	0.03
Nonfarm Nonres	1.28	1.50	0.96	0.53	0.32	0.09	0.01	0.00	0.03	0.06	0.13	0.15	0.13	0.08	0.05
Multifamily	2.10	1.63	0.79	0.52	0.32	0.15	0.04	0.05	0.01	0.03	0.04	0.08	0.03	0.04	0.04
C&I Loans	1.79	1.31	0.74	0.27	0.25	0.26	0.28	0.42	0.57	0.81	1.47	1.81	1.29	0.54	0.27
All Loans	1.61	1.28	0.86	0.52	0.51	0.60	0.66	0.67	0.62	0.69	0.97	1.14	0.91	0.61	0.54

Note: Prior to 1991, Net Charge-off data is not available by loan type

Note: Net charge-off rate is net charge-offs divided by average outstanding loan balance for the respective loan category.
Source: Call Reports

Comment: *[P]rovide information as to how many institutions would trigger additional scrutiny under the proposed guidance based on their reported commercial real estate lending and capital, particularly among smaller institutions.*

Response: As the proposed guidance suggests, the agencies are focusing on institutions with concentrations in construction loans and loans secured by non-owner occupied CRE. The current versions of the Call Report and Thrift Financial Report (i.e., regulatory financial reporting data) do not separate commercial real estate loans on owner-occupied properties from commercial real estate loans on non-owner-occupied properties.[3] As a result, the agencies can only estimate the number of institutions that would be subject to the risk management expectations in the proposed guidance.

[3] The agencies have approved changes to the Call Report and Thrift Financial Report to provide further detail on owner- and non-owner-occupied CRE loans. This reporting change is being phased-in with most institutions reporting additional detail starting with the March 31, 2007, filing. Institutions with less than $300 million in total assets that do not meet a percentage test will begin reporting additional detail in March 31, 2008. Refer to the notice on these revisions at http://www.ffiec.gov/pdf/ffiec_forms/FFIEC031_041_FIL7_20060127.pdf

Based on December 30, 2005, regulatory financial reporting data, approximately 2,600 banks and 200 thrifts would meet at least one of the two benchmarks in the proposed guidance, representing 33 percent of insured commercial and savings banks and 23 percent of thrifts.[4] However, when we apply the more narrow CRE definition in the proposed guidance (which excludes owner-occupied properties) to their portfolios, we estimate that the number of institutions subject to the proposed guidance would be between 1,700 and 2,000 institutions. This estimate is based on supervisory information that suggests a range of 30 to 50 percent of banks' CRE portfolios are secured by owner-occupied real estate and, therefore, would be excluded from the proposed definition of CRE.

The proposed benchmarks are intended to serve as preliminary screens to identify institutions that may have heightened CRE concentration risk. For those banks or thrifts exceeding these benchmarks, an institution would conduct further analysis to determine the underlying risk of its CRE portfolio. Based on this additional analysis, an institution with a concentration would be expected to demonstrate the risk characteristics of its CRE portfolio, including diversification across property types, markets, and borrowers. This is consistent with existing regulations that already require banks and thrifts to have written policies establishing limits and standards for real estate loans.

The proposed guidance will enable supervisors to focus attention on institutions with higher risk profiles and less robust risk management and, in turn, reduce the burden on institutions that are adequately addressing their CRE loan portfolio risks. This is consistent with our overall risk-focused approach to supervision.

Comment: *[W]hat proportion of those institutions have commercial real estate portfolios that are concentrated primarily in multi-family housing as opposed to purely commercial projects.*

Response: The table below shows the number of banks and thrifts that would meet the 300 percent CRE concentration threshold (columns 2 and 5) based on December 30, 2005, regulatory financial reporting data. Columns 3 and 6 show the subset of the institutions meeting the 300 percent threshold that also have a concentration in multifamily loans, defined for purposes of this analysis as those exceeding 200 percent of risk-based capital or "primarily" concentrated in multifamily housing. As expected, there is a higher proportion of thrifts with concentrations in multifamily loans, approximately three percent of the total number of thrifts versus less than one percent of commercial and savings banks.

[4] As of year-end 2005, there were 7,968 commercial and savings banks and 863 thrifts.

Number of Institutions Exceeding 300% Concentration in CRE Loans and 200% Concentration in Multifamily Loans (as of 12/31/2005)

	Commercial & Savings Banks			Thrifts		
	(1)	(2)	(3)	(4)	(5)	(6)
Asset Size	Total Number	Total CRE > 300% Risk-based Capital	Total Multifamily >200% Risk-based Capital	Total Number	Total CRE > 300% Risk-based Capital	Total Multifamily >200% Risk-based Capital
<$100M	3,568	438	2	296	21	0
$100-$1B	3,877	1,733	17	460	129	16
$1B-$10B	434	228	9	78	33	8
>$10B	89	12	3	29	1	1
All	7,968	2,411	30	863	184	25

Source: Call Report and Thrift Financial Report

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NATIONAL ASSOCIATION OF REALTORS®'

Statement on:

"A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate"

For Submission to the

Subcommittee on Financial Institutions and Consumer Credit

September 14, 2006

Introduction

The National Association of REALTORS® (NAR) is pleased to submit this Statement for the Record to the Subcommittee on Financial Institutions and Consumer Credit of the Financial Services Committee in connection with its hearing on the Basel Accords and commercial real estate. We appreciate the time and effort that its members, including Committee Chairman Michael Oxley and Subcommittee Chair Spencer Bachus and Ranking Member Bernie Sanders, have spent on this very important issue, and we look forward to working with you to address the concerns we have with the Basel Accords and the proposed guidance on commercial real estate lending.

The National Association of REALTORS®, "The Voice for Real Estate," with over 1.3 million members, is America's largest trade association, including NAR's five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,500 local associations or boards, and 54 state and territory associations of REALTORS®. NAR is concerned that the combined effects of the Basel Accords with the proposed guidance on commercial real estate lending could unnecessarily reduce the flow of capital to commercial real estate and hurt commercial real estate markets. Because the proposed regulations appear to tighten capital requirements more than appropriate considering the risk profile of commercial loans, NAR asks that the subcommittee to help ensure that the proposed commercial real estate lending guidance and Basel I-A requirements are revised to ensure that the flow of capital to commercial real estate is not diminished.

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NAR's Statement on

"A Review of Regulatory Proposals on Basel Capital and Commercial Real Estate"

The commercial real estate market is robust and enjoys a stable outlook. According to NAR's Commercial Real Estate Outlook of September 12, 2006, large institutions are increasing their investment in commercial real estate. Institutions (such as life insurance companies, pension funds, and life insurance companies) are generally risk averse and base their investment decisions less on the fluctuations of interest rates, and more on the overall health and stability of the commercial real estate market. During the first eight months of 2006, institutional investors and private equity funds accounted for over one half of office building sales volume, and one third of industrial property sales[1]. The increase in investment in commercial real estate from institutional investors demonstrates that a market downturn similar to that of the late 1980's and early 1990's is highly unlikely.

NAR's most recent Commercial Real Estate Outlook also notes that the increase of energy and construction costs have prompted a slowdown in the development of speculative real estate. This means that for the foreseeable future, commercial real estate will remain a landlords' market and that vacancy rates should remain historically low. Furthermore, as noted in our detailed comments on Basel IA below, both the FDIC and the Federal Reserve have noted in the past year that the risk management practices and the underwriting procedures of most financial institutions have improved significantly since the early 1990s.

Despite the strong overall long-term outlook for the commercial real estate markets, the financial regulators have issued proposed guidance on commercial real estate lending that takes a broad brush approach to rein in banks that have relatively high concentrations of commercial real estate loans, and through an advance notice of proposed rulemaking for Basel I-A have implied an intention to revise Basel I in ways that, in effect, would increase the risk weighting for commercial real estate from where it is now and as compared to what is being proposed under Basel II. We do not understand the basis for that result.

NAR favors the establishment of commercial real estate risk management guidelines that preserve and strengthen the safety and soundness of the banking system while not unduly harming the flow of capital to commercial real estate. At the same time, NAR also recommends the recalibration of Basel I-A to make it more responsive to the nuances of the commercial real estate marketplace. In both the proposed guidance on commercial real estate lending and the Basel I-A accords, NAR recommends that the regulators consider the performance characteristics of different classes of commercial real estate, noting that the performance in one sector is not necessarily related to that in another.

Summary of NAR Concerns:

Proposed Guidance on Concentrations in Commercial Real Estate Lending:

On January 13th, the federal regulators (Fed, FDIC, OCC, OTS) issued a proposed guidance on commercial real estate lending targeted to banks that have high concentrations in commercial real estate loans. The goal, ostensibly, is to mitigate against the potential economic fallout if the

[1] NAR Commercial Real Estate Outlook, September 2006.

commercial real estate market significantly slows. The guidance recommends enhanced risk management practices, that if implemented could potentially harm the flow of capital to commercial real estate. In NAR's letter comment letter to the financial regulators (attached), we expressed concern that the "impact of overly restrictive risk management practices that does not fully recognize the unique character of commercial real estate lending could increase the cost of capital and dissuade financial institutions from making loans to sound commercial real estate ventures.

NAR's recommendations:

- Recognize that different classes of commercial real estate lending have different performance characteristics. Not all commercial real estate exposures are the same.
- Financial institutions should be able to effectively manage risk through creating CRE portfolios that are diverse in exposures to different classes of commercial real estate in different regional markets.
- Failure to recognize distinctions in classes of commercial real estate could have the unintended consequence of driving property values in all classes of commercial real estate down, due an increase in the cost of capital.

Basel I-A:

The Basel Accords determine the process by which banks determine that capital they must hold in reserve to meet regulatory requirements. The Basel II accords apply to the 10 largest banks, while the Basel I accords apply to the smaller banks. The regulators began revising the Basel I accords to even out the competitive advantages that some perceive that Basel II gives to the larger banks. The accords develop a series of risk weights that attempts to account for the credit of the borrower against the risk certain lending classes pose. In October 2005, the financial regulators published an advanced notice of proposed rulemaking that proposes changes to the capital requirements of real estate loans. NAR commented that the proposed rules were an important first step in equalizing the inequalities between Basel II and BaselI.

NAR's recommendations:

- **Residential:** The proposed risk weights for residential (1 to 4 family) first lien mortgages are too high (at 35% for loans with 70%-80% loan to value ratios) and would put the smaller Basel I banks at a disadvantage to the larger Basel II banks which have a lower risk weighting for these types of loans. For example under Basel II the capital charge for these loans is 29 basis points, for Basel I banks it is 140 basis points. NAR recommends a risk weight for loans with an LTV under 70% at 10%, and a risk weight for loans with an LTV between 70% and 80% at 20%.
- **Private Mortgage Insurance (PMI):** The risk weighting for residential mortgages should reflect the protections that PMI provides.
- **Multifamily Residential Mortgages:** NAR recommends more favorable treatment for loans to commercial property that have a history of high occupancy levels.

- **Commercial Real Estate:** The Basel I ANPR (advanced notice of proposed rulemaking) moves commercial real estate loans to a higher than 100% risk weight, unless the loans satisfy prudential lending guidelines and the loan is supported by substantial equity (i.e. more than 15% of the completion value). NAR recommends that Basel I-A emulate the commercial real estate categories in Basel II -- Income Producing Real Estate (IPRE -- which includes office, hotel etc) with a risk weight of 50%, and 100% risk weighting to high volatility commercial real estate (HVCRE -- such as loans to speculative development and properties with specialized uses.)

Below are NAR's detailed analyses of both the Basel IA ANPR and the Proposed Guidance on Commercial Real Estate Lending which further underscores the need to set more appropriate guidelines and risk weights.

Basel I-A: *NAR urges regulators to consider protections of Private Mortgage Insurance, and the different real estate classes within commercial real estate.*

Background:

Under current regulations, banking and thrift institutions (banking organizations) are subject to a risk-based capital standard that is based on an international understanding reached by the banking regulators and central bankers of the leading economically developed countries in Basel, Switzerland, in 1988. This accord is commonly referred to as the Basel I capital framework, and it was implemented in this country beginning in 1989. Under the framework, the assets of banking organizations are assigned various "risk weights" based upon the relative credit risk of the asset, as determined by the regulatory agencies. Under the current standard, prudently underwritten mortgage loans are assigned to the 50 percent risk weight basket, and commercial real estate loans are assigned to the 100 percent risk weight basket.

More recently, the international and U.S. banking regulators and central bankers determined that the Basel I framework is in need of improvement. They believe that the current system does not accurately reflect the true economic risk of the various credits booked by banking organizations. Thus a mismatch exists between the true economic risk and the capital requirement imposed by the banking agencies. Further, the existing standard does not recognize many of the techniques a banking organization may use to mitigate risk, and therefore does not provide an incentive to take these measures.[2]

In recognition of these and other shortcomings, the international regulators developed a new capital framework, referred to as Basel II that will more closely align capital and risk. However, in the U.S. only a relatively handful of the largest banking organizations will be subject to this new framework due to the complexity of the standard and the need for each institution to utilize

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2 See, e.g. FDIC Staff Study, "Basel and the Evolution of Capital Regulation" (January 14, 2003).

costly and very sophisticated information management systems to comply with the requirements of the new framework.[3]

As a result, concerns have been raised that the banks subject to the new capital framework may gain a competitive advantage with respect to institutions subject the Basel I standards.[4] This concern is especially relevant in the area of home mortgage lending, where the capital requirement is predicted to be dramatically less for Basel II institutions.[5] As explained by one prominent banking trade association, the lower capital will most likely result in a cost advantage, and correspondingly a pricing advantage, in retail credits for Basel II banks. If community and other non-Basel II banks and thrift institutions are subjected to unfair competition from the largest banks, their ability to provide financial services to their communities and their profitability will suffer. The inevitable result will be further consolidation within the banking industry, resulting in an undesirable loss of locally focused institutions.[6] These smaller institutions are locally owned and run, and have expertise and detailed knowledge about their towns and communities that is not possible for larger national and regional organizations. The loss of these smaller institutions would result in an incalculable loss to the economy and vitality of our nation's heartland and the small business community nationwide.

Similarly, it is also important that, within the Basel I-A universe of depository institutions, the capital requirements be based on the relative risk of various activities so, for example, a thrift that makes real estate lending the primary focus of its business plan is not unfairly disadvantaged compared to larger lenders with other business plans.

The ANPR issued by the Federal banking agencies on October 20, 2005, is the agencies' attempt to deal with these concerns by making adjustments in the Basel I standard so that it is more risk sensitive, but without the regulatory burdens that will be required under Basel II. In so doing, the ANPR also seeks to address the competitive issues that are of great concern to the NAR, by

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[3] Joint Federal Banking Agency Press Release, "Agencies Announce Publication of Revised Capital Framework and Describe U.S. Implementation Efforts" (June 26, 2004).

[4] See, e.g. Statement of Acting Comptroller Julie Williams, Before the Subcommittee on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (May 11,2005) "(T)he OCC and the other agencies have focused considerable effort and attention on the potential competitive effects of the Basel II framework on the U.S. financial services industry.... (W)e are concerned that Basel II may create or exacerbate relative advantages between large domestic banks and mid-size/small domestic banks...(I)t is imperative that the U.S. agencies remain sensitive to these concerns...."

[5] Based on a survey of banking organization subject to Basel II, the capital requirements for residential mortgage loans will decline, on average, 62 percent, and the capital requirement for home equity lines of credit will decline, on average, by 74 percent, from the capital required for non-Basel II institutions. See, Statement of Richard Riccobono, Acting Director, Office of Thrift Supervision, before the Subcommittee on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (May 11, 2005).

[6] Statement of the Independent Community Bankers of America, before the Subcommittee on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (May 11, 2005). This concern was also raised by the trade association representing savings associations. See, Statement of America's Community Bankers, before the Subcommittee on Financial Institutions and Consumer Credit of the House Comm. on Financial Services (May 11,2005).

mitigating some of the disparity in capital requirements between Basel II and non-Basel II institutions.

In this regard, the ANPR makes a number of very positive suggestions that will help alleviate many of the concerns we have about the Basel II standards. We appreciate the agencies' concerns in this regard, and believe that the Basel I-A proposal is a positive step. However, we also believe that there is room for some improvement. We are therefore offering the following suggested changes with respect to the treatment of both residential and commercial real estate loans and lines of credit.

Recommendations:

1. One-to-Four Family Mortgages

Under current regulations, most one-to-four family first mortgages are eligible for a 50 percent risk weight. The ANPR states that this "one size fits all" approach does not adequately assess the credit risks posed by such loans. Instead, the ANPR proposes to assign a risk-weight to first lien one-to-four family mortgage loans after taking into account other factors, such as the loan-to-value (LTV) ratio of the loan, the credit-worthiness of the borrower (determined by a credit rating such as a FICO score), debt-to-income ratio, or some other measure of credit quality. These mortgages would then be assigned a risk weight basket of between 20 and 100 percent.

More specifically, the joint ANPR proposes that first lien one-to-four family mortgage liens with an LTV ratio of 70 percent or less be placed in the 20 percent risk weight basket, and mortgage loans with an LTV above 70 percent and up to 80 percent be placed in the 35 percent risk weight basket. We believe that in light of the very low credit risk posed by first lien residential mortgage loans the risk weights suggested in the joint ANPR are too high. Similarly, in light of the favorable capital charge that would be imposed on these loans under Basel II, the weight baskets suggested in the joint ANPR would not adequately deal with the competitive advantages Basel II provides to larger mortgage lenders.

There is no question that prudently underwritten first lien residential mortgage loans have historically low loss rates. According to Federal Reserve Board data, the average charge-off rate for these loans from 1991 through the 3rd quarter of 2005 was 0.15 percent.[7] As a result, the Tier 1 capital charge for these loans under Basel II is predicted to be as low as 12 basis points for well-qualified borrowers.[8] Under the joint ANPR, this same loan would result in a Tier 1 capital charge of 80 basis points, assuming the loan qualifies for the 20 percent basket as proposed in the joint ANPR.

[7] Board of Governors of the Federal Reserve System, Charge-Off and Delinquency Rates, Not Seasonally Adjusted. (Dec. 2005).

[8] Calem and Follain, "Proposed Competitive Impacts of Basel II in the U.S. market for Residential Mortgages," statement before the House Subcommittee on Financial Institutions and Consumer Credit 35 (May 11, 2005). According to this study, under Basel II, the capital charge for a first lien mortgage loan to a borrower with a FICO credit score 740 and with an LTV of 70 percent could be as low as 12 basis points.

Under Basel II, if the same well-qualified borrower took out an 80 percent LTV mortgage loan, the Tier 1 capital charge would be 29 basis points. But under the joint ANPR, the capital charge for the non-Basel II bank would be 143 basis points, assuming the loan qualifies for the 35 percent basket as proposed in the joint ANPR.

Thus, the reduction in capital suggested in the joint ANPR would still leave a wide gap in the treatment of mortgage loans with equivalent risks. This large difference will create competitive inequalities between mortgage lenders and could easily lead to further consolidation in the mortgage lending industry. We therefore recommend a risk-weight basket of 10 percent for prime first lien residential mortgage loans with a 70 percent or lower LTV, and a risk-weight basket of 20 percent for prime mortgage loans with a LTV above 70 percent and up to 80 percent.[9] Finally, we recommend that corresponding changes should also be made to the risk baskets for residential mortgage loans with LTVs in excess of 80 percent to more accurately reflect the risk of these loans. These adjusted baskets would make the Basel I-A approach more risk sensitive and would reduce (but not eliminate) the competitive disparity between the two systems.

2. Private Mortgage Insurance

The joint ANPR states "(B)anking organizations would determine the LTV of a mortgage loan after consideration of the loan-level private mortgage insurance (PMI) provided by an insured with an NRSRO[10]-issued long-term debt credit rating of single A or higher." We agree that PMI provides valuable credit risk mitigation and should be recognized under the capital standards. However, we disagree that PMI should not be considered when issued on a portfolio basis. Rather, we believe that PMI provides credit protection whether written on an individual loan basis or on a portfolio basis, and urge that the new capital standards recognize the benefits provided by both pool and individual loan insurance coverage.

We also disagree with the position that no capital credit should be given if the PMI contains a deductible under which the lender is required to absorb a first loss. PMI mitigates credit risk even if the lender is required to absorb a first loss, provided that the banking organization is willing to hold dollar for dollar capital against the amount of its potential first loss liabilities. If so, the banking organization should be permitted to treat the PMI as if it has no deductible. This modification would be especially important when considering a large portfolio of mortgage loans and the PMI deductible is relatively small.

3. Non-Traditional Mortgage Products

The ANPR notes that the Federal banking agencies are reviewing non-traditional mortgages, such as loans that permit negative amortization and loans that have an LTV in excess of 100 percent. The ANPR asks if these products should be dealt with in the general mortgage matrix, or if they warrant a higher capital treatment.

[9] These baskets would result in a Tier 1 capital charge of 40 basis points and 80 basis points, respectively.

[10] Nationally recognized statistical rating organization.

These loans can raise significant safety and soundness concerns if not properly underwritten. NAR is concerned that many borrowers do not understand the risk that come with these mortgages and is urging REALTORS® to help educate consumers about both the risks and rewards of nontraditional mortgages. However, when properly underwritten by the lender and fully understood by the borrower, non-traditional loans are often an appropriate product that provides useful alternatives for both high, middle and lower income families, especially in high-cost areas. For example, for a high income mortgagor, a low or zero down payment loan can be a useful method to provide funds for other investments at a relatively low cost to the borrower. For a middle-income borrower, non-traditional mortgage products may be used to provide a low cost source of funds for retirement plans or to provide for college savings. For many families, especially lower income families and families in high-cost areas, non-traditional loans increase the affordability of home ownership and provide a responsible method for people early in their careers to purchase a home without a large down payment.

As noted, non-traditional mortgage loans can create safety and soundness concerns when not properly underwritten. However, this is true for any type of loan that does not meet prudent underwriting standards. The failure of a banking organization to properly underwrite an extension of credit should be dealt with through the normal supervisory and examination process, and not through a capital charge that will unnecessarily penalize both banking organizations and consumers. In this regard we note that the Federal banking agencies recently published proposed guidance relating to non-traditional mortgage loans. We believe that both the guidance and any special capital rules must take a balanced approach so carefully underwritten and fully understood nontraditional mortgages remain available for borrowers to achieve homeownership, consistent with safety, soundness, and consumer protection.

4. Second Liens and Credit Lines

The joint ANPR proposes increasing the risk weight for second mortgage liens and home equity lines of credit if the combined LTV ratio of the first lien and second lien or line of credit exceeds 90 percent. The joint ANPR suggests that the risk weight for such loans could exceed 100 percent.

The risk weights for an unsecured retail loan or line of credit is 100 percent. The Basel II Accord states: "No transaction in which CRM (credit risk mitigation) techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not used."[11] Credit risk mitigation techniques include collateralization requirements.[12] This principle should apply equally to both Basel II institutions and Basel I-A institutions. It simply makes no sense to penalize a bank for taking collateral when the institution could make a similar loan without collateral. We believe that to the extent that some second loans or lines of credit raise supervisory concerns, these concerns should be dealt with through the normal supervisory process and not through the capital standards.

[11] Basel II Accord par. 113.

[12] Basel II Accord par. 119.

5. Multi-Family Residential Mortgages

The joint ANPR notes that except for certain specially qualified multifamily residential loans, these loans are generally assigned a risk weight of 100 percent. The ANPR asks whether these loans, or a subset of these loans, should be placed in a lower risk weight basket.

The NAR believes that multifamily residences with a history of high occupancy and revenue generation are much less risky than other, more speculative multifamily loans, that the risk weight for these loans should be lowered in order to more accurately reflect the risk of these assets.

This would be consistent with the Internal Risk-Based approach authorized under Basel II. Under this approach, which would be available for large U.S. banking organizations, loans secured by multifamily residential real estate in which the funds for repayment are generated by rental income are treated as "Income Producing Real Estate" (IPRE). This group of assets is generally afforded a lower risk weight than loans secured by other types of commercial real estate.[13] Likewise, we believe that a loan secured by a multifamily residential project with a high occupancy rate and history of revenue generation should also be treated more favorably.

6. Commercial Real Estate

The Basel I framework assigns commercial real estate loans to the 100 percent risk weight basket. The joint ANPR proposes to move these loans to a higher than 100 percent risk-weight basket, unless the loan satisfies the prudential real estate lending guidelines and the loan is supported by a substantial equity investment by the borrower, such as 15 percent of the completion value.

We acknowledge that commercial real estate lending contributed to many of the banking problems in the late 1980s and early 1990s. However, since that era, many of the practices associated with commercial real estate lending have been modified, and this sector has demonstrated a very impressive history of safety and soundness. Statistics complied by the Federal Reserve Board indicate that for the past 10 years the average charge-off rate for commercial real estate loans is only 0.10 percent.

According to the FDIC, the dynamics of the commercial real estate sector have changed dramatically since the early 1990s. Public markets now play a much larger role in commercial real estate financing, due to the development of the commercial mortgage-backed securities

[13] Under the Basel II internal risk-based approach commercial real estate is divided into two categories: income-producing real estate (IPRE) and high-volatility commercial real estate (HVCR).[13] IPRE is characterized by the fact that the repayment of the loan is based on cash flows generated by the real estate, such as rent payments. HVRE is characterized by loans secured by real estate in repayment is based on the future sale of the property, such as loans for the acquisition, development and construction of a new housing development. IPRE loans are generally given a lower risk weight than HVCR loans with similar probabilities of default. For example, a "strong" IPRE loan (with a low probability of default) is assigned a risk weight of 70 percent, but a HVCR loan with a similar probability of default is assigned a risk weight of 90 percent.

(CMBS) market in the early 1990s. The success of the CMBS market then contributed to tremendous growth in the secondary market for distressed properties. The CMBS market has grown to more than $550 billion. In the mid-1990s, real estate investment trusts (REITs) also became a major force in financing CRE, with more than a seven-fold increase in market size in the past 10 years.[14]It also appears that the CMBS and REIT markets have taken on a larger share of the traditionally higher-risk types of loans.

A recent FDIC study in the Atlanta MSA that found that "(I)nsured institution risk controls and monitoring programs have improved significantly since the early 1990s. Overall, bank management has implemented more effective grading systems, improved control and approval limits, and adequate loan review procedures. Bankers understand current conditions and issues in submarkets and have access to a broader range of market information."[15] A study by the Federal Reserve Bank of Philadelphia in 2005 also noted that "current real estate underwriting and risk management practices are considered to be materially better than in the late 1980s and early 1990s, and there is presently no evidence of emerging systemic problems in the banking sector."[16]

These improvements in CRE lending were also recognized by the Basel Committee. Under the Basel II standardized approach, loans secured by commercial real estate will generally be assigned to the 100 percent risk weight basket.[17] However, in certain circumstances, mortgages on office or multi-purpose commercial premises may be assigned to the 50 percent risk weight if they meet certain LTV and other requirements.[18] We are not advocating in this letter to assign a 50 percent risk weight for commercial real estate lending, but we strongly believe that placing these loans in a weight basket in excess of 100 percent would not be appropriate. This especially would be the case where other factors are present indicating that the loan is not risky, such as when the borrower has made a substantial equity investment in the project, where the project is pre-sold under legally binding commitments, or where the project meets the requirements for Income Producing Real Estate (IPRE).[19]

NAR supports the efforts of the Federal banking agencies to improve the current Basel I standards in order to make this standard more risk sensitive and to lessen the potential competitive issues that may arise when banks implement Basel II. The NAR believes that this effort would be advanced by authorizing a lower risk weight basket for commercial assets that

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[14] FDIC, "Supervisory Insights: Assessing Commercial Real Estate Portfolio Risk." (June 25, 2004).

[15] Id. at 4.

[16] Federal Reserve Bank of Philadelphia, SRC Insights, "SVP Commentary on Top Commercial Real Estate Trends." (Second Quarter 2005). The study noted that there were poorly managed CRE concentrations in some institutions, and that bank supervisors should monitor CRE lending carefully.

[17] Basel II Accord par. 64.

[18] Basel II Accord par. 64, fn.29.

[19] See discussion above on multi-family residential mortgages and footnote 13.

more accurately reflects their risk and their treatment under Basel II. We also believe that the proposal should be modified to reflect various forms in which PMI may be used to mitigate credit risk. The NAR believes that a punitive capital charge on non-traditional mortgage loans is not appropriate, and that any safety and soundness concerns with these products should be dealt with through the supervisory process. We likewise oppose a punitive capital charge for commercial real estate loans, which, according to the banking agencies, are performing well and being underwritten prudently. Finally, as a general matter, we do not believe that the capital standards should impose a higher capital requirement for collateralized loans when a banking organization could make the same loan without collateral. We thus oppose assigning second liens and home equity lines of credit to a risk weight in excess of 100 percent.

Proposed Guidance on Commercial Real Estate Lending: *NAR urges regulators to consider emphasizing the diversity of the commercial real estate markets.*

Background:
The regulators have observed that some insured financial institutions have high and increasing concentrations of CRE loans on their balance sheets, and are concerned that these concentrations may make institutions more vulnerable to losses during commercial real estate cycles. While the regulators have previously issued regulations outlining supervisory expectations for a safe and sound CRE lending program, this proposed guidance is intended to reinforce existing guidance as it relates to institutions with elevated levels of concentration in CRE loans.

The guidance notes that in the past "weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system," and that "recent examinations have indicated that the risk management practices and capital levels of some institutions are not keeping pace with their CRE concentrations."[20] The regulators propose that financial institutions with CRE concentrations adopt additional risk management measures to provide an additional safeguard against market fluctuations.

The regulators propose to define CRE loans as exposures "secured by raw land, land development and construction (including 1-4 family residential construction), multifamily property, and non-farm non residential property where the primary or a significant source of repayment is derived from rental income associated with the property." The definition also includes loans to REITs and unsecured loans to developers that closely correlate to the risk in commercial real estate markets. Concentrations that warrant heightened risk management practices would be defined as:

- Total reported loans for construction, land development, and other land represent 100% or more of the institutions total capital; and
- Total reported loans secured by multifamily and non farm non residential properties and loans for construction, land development, and other land represent 300% of the institutions total capital[21].

[20] Federal Register Vol. 71, No. 9 Friday, January 13, 2006, Notices page 2304.
[21] Ibid, p. 2305

According to the regulators, financial institutions meeting or exceeding these criteria should have heightened risk management practices. The following areas of the proposed guidance are of interest to NAR:

- Risk Assessment and Monitoring of CRE Loans: Financial institutions should maintain thoroughly articulated policies that specify criteria for risk rating CRE exposures. The risk ratings should take into account the property's sensitivity to changing market conditions.

- Portfolio Risk Management: Institutions should measure and control CRE credit risk on a portfolio basis by identifying and managing concentrations, performing market analysis, and stress testing. Risk management practices should include:

    - Management Information Systems: Institutions should stratify the portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating.
    - Market Analysis: Institutions should perform on going evaluations of the market conditions for the various property types and geographic areas or markets represented in their portfolio.
    - Portfolio Stress Testing: Institutions should consider performing portfolio level stress tests of their CRE exposures to quantify the impact of changing economic scenarios.

- Capital Adequacy: Financial institutions with CRE concentrations should recognize the need for additional capital support, beyond what is regulatorily required, for CRE concentrations in its strategic, financial and capital planning[22].

The proposed guidance provides positive recommendations for financial institutions to strengthen their risk management practices should they develop concentrations in CRE lending. It is our understanding that numerous financial institutions have similar risk management programs in place, and generally adhere to the FDIC's rules on real estate lending standards. This proposed guidance seems to be intended to address institutions who may be tempted by overheated local markets to increase exposure to certain classes of real estate lending.

Recommendation:

NAR supports agency efforts to ensure that institutions provide CRE loans based on sound underwriting principles with the finance charges priced appropriately to reflect the economic risk of each loan, however we are concerned that an overly stringent, or inconsistent application of the guidelines, may cause financial institutions to not lend to worthy projects, and as a consequence, harm the commercial real estate markets and depress property values.

[22] ibid, p. 2306-2307

Consistent with our comments that regulators should treat different classes of real estate lending separately under Basel I-A, NAR believes that the proposed guidance should emphasize that portfolio diversity can be achieved through different types of CRE loans with varying degrees of risk. NAR recommends that regulators encourage diversity of CRE exposures across classes of commercial real estate and markets. Commercial real estate is often divided into the following classes: office, industrial, retail, multifamily condo, multifamily rental, and hospitality, each with unique performance characteristics. Though each class is tied to the overall health of the economy, some classes are more susceptible to market fluctuations than others. As part of a financial institution's portfolio risk management, NAR believes that financial institutions should be able to effectively manage risk through creating CRE portfolios that are diverse in exposures to different classes of commercial real estate in different regional markets.
The Regulators should carefully consider the effects of a revised risk-based capital regimen combined with increased risk management safeguards on the commercial real estate markets. Financial institutions may be dissuaded from making loans to, or unnecessarily raise the cost of capital for, sound commercial real estate ventures. This could hurt commercial real estate markets and depress property values. NAR has asked the regulators to carefully evaluate the potential impact the proposed guidance could have on the real estate markets before finalizing the proposed guidance.

Conclusion:

NAR believes that the commercial real estate lending guidance and the changes to Basel I-A under consideration should take into account the strength and soundness of the commercial real estate markets. so Otherwise, banks may be dissuaded from making sound commercial real estate loans and the agencies may unnecessarily and inadvertently limit the flow of capital to commercial real estate. To do so would depress property values and harm the economy beyond what is appropriate to assure safety and soundness of banks.

As noted above, institutional investors are significantly increasing their commercial real estate holdings . This is evidence of the long-term strength and stability of the commercial real estate market. Furthermore, as noted in our discussion of Basel I-A issues, studies by the FDIC and Federal Reserve underscore the point that underwriting procedures and risk management practices have improved dramatically since the late 1980's and early 1990s.

NAR is also concerned that potential revisions to Basel I-A capital requirements and the proposed commercial real estate lending guidance may put smaller banks at a significant competitive disadvantage to the larger Basel II banks. Basel II banks are likely to enjoy more favorable risk weights on commercial loans, and, therefore, hold a much broader and larger loan portfolio, and are much less likely to develop concentrations in real estate lending.

NAR looks forward to working with members of the Subcommittee and the financial regulators to ensure that the commercial real estate markets remain strong.

We appreciate this opportunity to express our views on these important issues.