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John M. Reich, Director
Office of Thrift Supervision

concerning the

Development of a New Basel Capital Framework

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

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Testimony on the Development of a New Basel Capital Framework

by

John M. Reich

Director, Office of Thrift Supervision

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I. Introduction

Good morning, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. Thank you for the opportunity to discuss the views of the Office of Thrift Supervision on the development of the Basel II capital framework in the United States for our largest U.S. financial institutions and the parallel modernization of Basel I for our other institutions.

The development of Basel II has been underway, internationally, for a number of years. In the United States, the four Federal Banking Agencies (FBAs) commenced the formal rulemaking process with the issuance of an Advanced Notice of Proposed Rulemaking (ANPR) in 2003. The parallel modernization of domestic risk-based capital requirements stemming from Basel I (our current risk-based capital standards), aimed at institutions that will not adopt Basel II, has been discussed among the regulators for some time. It formally began, however, only a few weeks ago with the issuance of an ANPR.

The goal of Basel II is to produce a risk-based capital system that promotes effective risk management, maintains capital adequacy, and increases the transparency of risks undertaken by our largest, internationally active institutions. The goals of the FBAs are to ensure that Basel II, as implemented in the United States, and the parallel modernization of our current risk-based capital standards, will enhance the risk management, capital adequacy, and risk transparency of all our financial institutions, while maintaining the safest and soundest banking system in the world. OTS will endorse the implementation of systemic changes to our capital rules only if they advance these goals.

Although we are more than two years from the start of a proposed 4-year phase-in of Basel II, there are significant hurdles to overcome before we can represent to you, Mr. Chairman, that it is ready to be implemented. This is underscored by a recent quantitative impact study, QIS 4, conducted by the FBAs. QIS 4 indicated that further, significant revisions are needed before we can implement Basel II in the United States. We also need to resolve difficult policy issues in the modernization of our current risk-based capital standards. We remain committed to meeting the challenges raised in the development and implementation of both capital systems.

Today, I will address some of these issues and provide an update on the approach to risk-based capital contemplated by Basel II, as well as issues that our U.S. institutions are expected to face under a revised Basel I-based framework.

Given that the banking and thrift industries are profitable and well-capitalized, with few troubles in recent years, you may reasonably ask what is broken and why do we need to fix it? The answers start with the growing exposure of large and internationally active institutions to steadily increasing risks

that are not captured very well—if at all—under our current risk-based capital framework.

Much of the public debate about Basel II has been about changes in minimum regulatory capital; however, the new framework goes beyond that. It focuses first and foremost on enterprise-level risk management, and encourages ongoing improvements in risk assessment capabilities. Basel II also provides for governance changes, including board of director accountability for risk management. Basel II may allow for reduced minimum risk-based capital requirements for certain institutions, where a reduction is justified and commensurate with real and verifiable risk exposure. That would only be available, however, where an institution can demonstrate—to the satisfaction of its primary regulator—that its risk management capabilities and resultant risk reduction merit such a change in capital requirements.

There is also a need to modernize Basel I risk-based capital requirements in order to minimize competitive effects of adopting Basel II and to better align capital requirements with the wide range of risk profiles of domestic financial institutions.

II. Overview and Background of the Basel Process

A. Basel I

Basel I, issued 1988 by the Basel Committee on Banking Supervision (BCBS), provided a set of capital principles designed to strengthen capital levels at large, internationally active banking organizations, and to foster international

consistency and coordination.[1] Although Basel I applied only to the largest, internationally active banks in G-10 countries (countries outside the G-10 were encouraged to adopt it for their banks operating internationally), the themes of Basel I were intended to apply to all banking organizations worldwide, of any size and activity.

While OTS did not participate in developing Basel I, we applied it to the institutions we regulate, along with the other FBAs. Throughout implementation of Basel I, the FBAs developed risk-based capital standards consistent with its underlying principles, but with modifications intended to enhance risk sensitivity and conform to the unique needs of the U.S. banking system.

When Basel I was issued, the BCBS recognized that it was only a start, and that more refinement would take place over time. In today's sophisticated financial marketplace, Basel I is a relatively simplistic framework. For example, it makes no distinction between a well-underwritten commercial credit to a strong borrower and a relatively weak commercial credit to another borrower. Both are assigned the same (100 percent) risk weight. Similarly, residential mortgages, which can vary widely in quality, are assigned either a 100 percent risk weight or, if prudently underwritten, a 50 percent risk weight (most 1-4 family residential mortgages). Currently, even the lowest credit risk residential mortgages are subject to a 50 percent risk weight; whereas the highest credit risk residential mortgages are subject to no more than a 100 percent risk weight.

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1. The BCBS identified two fundamental objectives at the heart of its work on regulatory convergence under Basel I. As the BCBS stated, first, "the new framework should serve to strengthen the soundness and stability of the international banking system; and [second,] the framework should be fair and have a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks."

As stated by the BCBS, advances in risk management practices, technology, and banking markets have made the 1988 Accord's simple approach to measuring capital less meaningful for many institutions. Likewise, improvements in internal processes, more advanced risk measurement techniques, and more sophisticated risk management practices have dramatically improved the monitoring and management of risk exposures and activities. In short, the static rules of the 1988 Accord have not kept pace, and in fact, were not designed to keep pace with advances in risk management.

B. Basel II

As financial instruments, systems and products became more complex, the BCBS began designing a new regulatory capital framework. This framework, Basel II, incorporates advances in risk measurement and management practices, and attempts to assess capital charges more precisely in relation to risk, and in particular, credit risk and operational risk. The international agreement articulating these principles was issued in June 2004.

Basel II calls for institutions to measure and maintain internal data about different loan types for credit and operational risk. These requirements help to promote improved risk management systems. The FBAs also expect institutions to continue to develop and improve their internal economic capital models to more accurately measure their own unique enterprise risk. While Basel I focused on measuring risk exposure on an asset-by-asset basis, placing assets into simple, broadly defined risk buckets, Basel II focuses on enterprise-wide risk management, and encourages institutions continually to evaluate and assess their risk exposure.

There are numerous reasons for our U.S. banking system to move forward to a more sophisticated, risk-based framework for evaluating capital adequacy in institutions implementing Basel II. At the same time, it is important to identify ways to improve our Basel I-based system for the thousands of institutions that will not adopt Basel II. We believe that these objectives are not mutually exclusive, but rather mutually dependent in order to prevent potential competitive inequities between Basel II adopters and non-adopters.

III. Implementation of Basel II in the United States

While OTS supports the concepts, principles, and stated goals of Basel II, implementation in the United States will occur only when the FBAs are confident that it can be achieved in a manner that affirmatively strengthens and does not undermine our financial system. This requires us to maintain the safety and soundness of Basel II adopters and implement a modernized Basel I-based system that treats all U.S. institutions fairly and consistently regardless of the risk-based capital regime that they follow.

The FBAs recently revised the proposed Basel II timeframes to allow more time consistent with these principles. In addition to delaying the start to 2008 and adding an additional phase-in year, the FBAs provided for greater supervisory control over individual institutions at each step of Basel II implementation,[2] along with progressively less binding capital floors until fully implemented in 2012.[3]

2. The new timeframes provide for a non-binding "parallel run" of the Basel II framework starting in 2008; however, institutions may enter the parallel run only with the permission of their primary regulator. This will require an institution to demonstrate to its regulator that it has accurate and reliable systems in place for enterprise-wide risk management. During the parallel run phase, institutions seeking to implement the Basel II framework would also be required to comply with existing Basel I requirements.

3. The phase-in schedule provides that, in the first year (as early as 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

Throughout implementation, institutions would be subject to close supervisory scrutiny and a strict leverage ratio requirement.

While the FBAs have agreed to proceed with these safeguards in place, the Basel II implementation process remains dynamic. The FBAs are currently working on a Notice of Proposed Rulemaking (NPR) as a precursor to issuance of a rule implementing the Basel II framework in the United States.

In conjunction with issuance of an NPR, the FBAs plan to issue comprehensive proposed guidance consolidating previously issued guidance on retail, corporate and operational risk and including issues not previously addressed, such as securitization, credit risk mitigation, equity exposures, and various wholesale transactions. Industry reaction and comment on the consolidated guidance will be very important since it will be the first iteration of U.S. regulatory policy on some of these subjects. In addition, this will be the first opportunity for the industry to assess the adequacy of the guidance based on the standards enumerated in the NPR. The FBAs plan to make additional adjustments to the guidance after receiving industry comments and to ensure consistency with a final rule.

The FBAs are currently working toward issuance of a final rule in mid-2007, which is a critical timing issue for U.S. financial institutions to have sufficient lead-time to prepare for a 2008 parallel run. We recognize that the 2007 final rule may not even be the last word on Basel II. Rather, we anticipate that

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in risk-weighted assets would be limited to a 90 percent floor in the second year of implementation (as early as 2010), and an 85 percent floor in the third year (as early as 2011). Supervisory approval is required in each successive year to go to the next floor. During implementation, an institution's primary 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.

further rulemakings may be necessary to refine the Basel II framework for use in the United States based on our experiences during the parallel run and subsequent implementation stages.[4]

A. Modernization of Our Current Risk-Based Capital Standards

On October 19, 2005, the FBAs issued an ANPR announcing the start of the rewrite of Basel I-based domestic capital standards. OTS was an early advocate of revising and modernizing the existingstandards. We strongly support amending our current risk-based capital standards simultaneously, or in close proximity to, Basel II. Our view is that these revisions should encompass meaningful reforms, while avoiding imposing costly analytical processes on smaller banks and thrifts. Modifying the existing rules with more accurate risk-weights allocated to a wider range of asset buckets will significantly improve the current framework. Applying commonly used risk criteria for identifying different levels of risk will further enhance the existing framework. This would provide a more granular, risk-sensitive system of determining appropriate levels of capital, by asset type, and within asset type.

Modernization of Basel I-based capital standards will also mitigate potential competitive inequities that may arise with the implementation of Basel II.

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4. 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.

In considering revisions to our current capital rules, five general principles have guided the FBAs. These are:

- 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;
- Creating appropriate incentives for banking organizations; and
- Mitigating material distortions in the amount of regulatory risk-based capital requirements for large and small institutions.

The recently issued ANPR for modernizing our domestic risk-based capital standards focuses on a number of potential modifications. These include increasing the number of risk weight categories for credit exposures; using loan-to-value (LTV) ratios, credit assessments, and other broad measures for assigning risk-weights to residential mortgages—a particularly important issue for OTS; modifying the risk-based capital requirements for certain commercial real estate exposures; and increasing the risk sensitivity of capital requirements for other types of retail, multifamily, small business, and commercial exposures.

Two additional issues particularly important to OTS are expanding the number of risk weight categories to which credit exposures may be assigned;[5] and continuing to consider private mortgage insurance (PMI) in the risk-weighting of residential mortgages.

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5. 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.

As we consider modernizing our current risk-based capital requirements to increase its risk sensitivity and minimize potential competitive inequities, we realize that some banking organizations may prefer to operate under the existing Basel I framework, unchanged, to determine their minimum risk-based capital requirements. The ANPR anticipates this option and expressly invites comment. We expect additional comment about flexibility, and balancing safety and soundness with regulatory burden concerns.

B. The QIS 4 Survey

There have been a series of structured and coordinated information gathering exercises conducted internationally, referred to as Quantitative Impact Studies (QIS). The most recent data collection, QIS 4, was an important milestone in U.S. development of the Basel II framework. The FBAs initiated QIS 4 to gauge the potential impact of Basel II in the United States. Before discussing the results of QIS 4, it is important to note its inherent limitations.

In October 2004, the FBAs released the QIS 4 materials, and 26 institutions responded to the study. The initial results of QIS 4 revealed a material drop in required risk-based capital compared to Basel I requirements, and significant dispersion among the respondents with regard to the Basel II minimum risk-based capital requirement. As a result, this past April the FBAs delayed the planned 2005 issuance of the Basel II NPR in order to provide time to conduct additional analysis on the QIS 4 data.

Several important factors likely influenced the overall quality of the QIS 4 data. These include unsettled and/or incomplete guidance on Basel II from the FBAs, as well as the fact that many institutions are still developing the data and

systems required to fully implement Basel II. The QIS 4 process was instructive, however, on the state of readiness of—and need for additional preparation by—both the regulators and the industry.

Notwithstanding these factors, several aspects of the data bear further scrutiny. Chief among these was a material difference in required risk-based capital levels among respondents that was not fully explained by differences in their enterprise risk profiles. We are particularly concerned with analyses indicating materially disparate capital charges for credit exposures that generally pose comparable levels of credit risk.

Another unsettling aspect of QIS 4 was a material drop in overall risk-based capital. In fact, every category of credit risk showed declines in capital requirements except for credit cards. This is clearly an issue that requires further study to ensure that the Basel II capital standards are adequate.

With respect to mortgage lending, the QIS 4 results demonstrated large capital reductions for mortgage and home equity lending. While this is an especially important result because of commercial banks' existing concentration in mortgage-related assets,[6] some of the decline in capital for prime mortgage lending was expected because QIS 4 did not address interest rate risk—typically, one of the most significant risks for prime mortgage lending. In fact, the drop in capital for prime mortgages highlights the importance of realigning risk-based capital requirements to more closely correspond to actual credit risks, while also taking

6 Since 1995, commercial banks have increased their holdings of residential-related mortgages 174 percent in real dollars, from $991 billion to $2.72 trillion. As a percentage of assets, commercial bank holdings of residential-related assets have increased 40 percent, from 23.0 percent of assets in 1995 to 32.3 percent of assets today. By contrast, thrifts have increased their holdings of residential-related mortgages in real dollars by 62 percent, but as a percentage of assets thrift holdings are actually 4 percent lower than in 1995, from 75.6 percent of assets in 1995 down to 72.5 percent of assets today.

into account interest rate risk—a critical element in evaluating appropriate capital levels.[7]

In recognition of the substantial interest rate risk associated with many forms of mortgage lending, OTS has developed a rigorous interest rate risk model. It is our experience, working with our interest rate risk model for well over a decade, that savings associations have modified their interest rate risk-taking behavior based on information and tools provided by our model. How interest rate risk is ultimately treated under Basel II is an important issue for OTS and the thrift industry, as well as for banks that focus on mortgage lending activities.

A disturbing result from QIS 4 was the sizable reduction in required capital for home equity lines of credit. Since the end of 2000, home equity lines of credit on institution balance sheets have grown by an extraordinary 354 percent, to $534 billion. This is due, in large part, to the low interest rate environment of the last several years for mortgages and mortgage-related products. We are concerned that the study results may reflect only our recent experience, and not accurately portray risks present in a full economic cycle. This remains an area deserving of additional attention as we move forward with our rulemaking and the development of guidance on Basel II.

The results of QIS 4 suggest that Basel II remains a work in progress in the United States, both for the FBAs and institutions that intend to implement it. The FBAs are committed to creating a regulatory framework that resolves the concerns raised by QIS 4. There is a significant amount of work remaining to create a

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7. By their very nature, conservatively managed mortgage lenders typically have substantially lower credit risk exposure than lenders concentrating in other retail lending activities. A major risk for mortgage lenders, interest rate risk, is also greatly reduced by the presence of sound and prudent interest rate risk management practices, including access to the secondary mortgage market.

regulatory structure that ensures risk sensitive results, promotes fair competition, and ensures the continued safety and soundness of the U.S. financial system.

III. Public Policy Concerns with Basel II and the Modernization of Current Risk-Based Capital Standards

A. Timing

Implementing a more risk sensitive capital framework in the United States is an important objective, but we must be vigilant not to harm our existing banking system. Longstanding capital adequacy standards combined with a well-established and highly respected supervisory structure have delivered a banking system that is healthy and robust. OTS supports Basel II, provided its implementation enhances our existing banking system. It is important that we review this objective at each step of the way toward Basel II implementation.

As we take the steps necessary to move to a more advanced and risk sensitive capital framework, it is important to exercise caution and allow for sufficient time to consider how best to proceed in implementing Basel II in the United States. The safeguards we recently added, including a parallel run year, followed by three years of capital floors, and ongoing regulatory and supervisory review, will help us proceed prudently toward Basel II implementation.

B. Competitive Considerations

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 create competitive distortions. While global capital standards are important, we must avoid potential negative effects on U.S.-based institutions not operating internationally.

It is important to maintain comparable, although not necessarily identical, risk-based capital standards for all U.S. institutions with respect to lending activities that have the same risk characteristics. Although our largest institutions should receive capital treatment commensurate with their ability to reduce risk via diversification and technology, community banking organizations should not be competitively disadvantaged in the process. Competitiveness issues raised by Basel II necessitate an across-the-board examination of capital standards for all our institutions. This provides an opportunity to reexamine our current risk-based capital standards, and to take any appropriate steps to reduce potential competitive inequities for community banking organizations.

OTS is pleased that the modernization of Basel I-based capital standards, an initiative we championed, has evolved into a commitment by all the FBAs. The goal of this initiative is to achieve greater risk-sensitivity without undue complexity. We believe this can be accomplished by, among other things, increasing the available asset "risk-buckets" first enunciated under Basel I, and by applying commonly understood criteria for assessing the relative risk within and among various loan types.

As previously described, while Basel II includes minimum risk-based capital requirements for credit and operational risk, it does not include specific capital requirements for interest rate risk. OTS believes that this significant risk, especially important in mortgage products, should be addressed by the FBAs consistently. If the Basel II construct for interest rate risk is maintained, it will be

important to prepare comprehensive interagency guidance on how we expect this risk to be measured and managed by U.S. institutions implementing Basel II.

C. Leverage Requirements, Prompt Corrective Action, and other Safeguards

An issue garnering significant attention under Basel II is the interrelationship—and tension—between a risk-insensitive leverage ratio and risk-based capital requirements. On the one hand, the increased risk sensitivity offered by Basel II is intended to align risk-based capital requirements more closely with a banking organization's own internal capital allocation. A leverage requirement is fundamentally different, however, in that it constrains the extent to which an institution can leverage its equity capital base. In effect, a risk-insensitive leverage requirement—a backstop protecting the federal deposit insurance funds—potentially operates as a disincentive for an institution to invest in the least risky assets, while not constraining its investment in high-risk assets.

Prompt Corrective Action (PCA), which includes the leverage ratio constraint, was instituted in the late 1980s in response to the need for more aggressive and timely supervisory intervention in the face of stressed and declining capital levels. PCA provides a graduated capital structure for identifying categories of capital adequacy based on both leverage ratio and risk-based capital.[8]

PCA and its leverage ratio are based on institution-wide levels, rather than individual asset risks as prescribed by Basel II. Notwithstanding Basel II's focus on risk sensitivity, an institution with a concentration of low risk assets will be

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8. The FBAs currently define a "well-capitalized" institution as having Tier 1 capital of 5 percent, "adequately capitalized" is set at 4 percent, "under-capitalized" at less than 4 percent, "significantly under-capitalized" at less than 3 percent, and "critically under capitalized" at less than 2 percent Tier 1 capital.

constrained by the leverage ratio; as a result, its capital will not be risk sensitive. Conversely, the leverage ratio may impose no restraint on a relatively high-risk institution, yet that institution would be constrained, presumably, by an effective risk-sensitive standard. Thus, a risk-insensitive leverage ratio works against a financial institution's investment in low-risk assets.

Today's expanding universe of off-balance-sheet activity also goes untouched by existing leverage requirements. Thus, a regulatory capital system with a leverage ratio not sensitive to risk operates as the principal binding capital constraint on financial institutions, rather than a backstop measure. Such a system may perversely motivate low credit risk lenders to pursue riskier lending.

Along with other prudential safeguards, leverage is an important capital buffer. OTS remains firmly and unequivocally committed to maintaining an appropriate leverage ratio that is sufficiently rigorous and also flexible enough to address the unique operating characteristics of all types of lenders.

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. While it is important that the United States continue to move forward on Basel II, we should proceed in a cautious, well-studied, and deliberate manner. The revised timeframe for Basel II is consistent with this goal; however, it is critical that all interested parties—including the industry, Congress and the regulators—continue an active, open and thorough dialogue regarding Basel II. We will continue to work together with the Members of this Committee, the other FBAs, and with our international colleagues on these issues.

We stand ready to make any necessary adjustments to ensure that domestic implementation of Basel II, in conjunction with the modernization of Basel I-based capital standards, appropriately enhance capital adequacy and risk management in the United States. Most importantly, we will continue to seek assurance, Mr. Chairman, that these efforts not yield unintended consequences to our U.S. institutions.

Thank you, Mr. Chairman and Ranking Member Sarbanes, for holding this important hearing, and for the continued interest and hard work of you and your colleagues and staffs on these important issues. We will be happy to provide any additional information that you may require regarding the ongoing Basel II and Basel I rewrite processes.