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Richard M. Riccobono, Acting Director
Office of Thrift Supervision

concerning

Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study

before the

Subcommittee on Financial Institutions and Consumer Credit
and the
Subcommittee on Domestic and International Monetary Policy,
Trade and Technology

Committee on Financial Services
U. S. House of Representatives

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Testimony on Basel II: Capital Changes in the U.S. Banking System and the Results of the Impact Study
by
Richard M. Riccobono
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I. Introduction

Good morning, Chairman Bachus, Chairman Pryce, Ranking Members Sanders and Maloney and members of the Subcommittees. Thank you for holding this important hearing on Basel II and for your continued interest in this issue.

I particularly want to thank you, Chairman Bachus, for your legislative efforts to establish a mechanism for developing uniform U.S. positions on issues before the international Basel Committee on Banking Supervision (BCBS). In addition, Mr. Chairman, thank you for including in your bill, H.R. 1226, the United States Financial Policy Committee For Fair Capital Standards Act, a provision supporting Office of Thrift Supervision (OTS) representation on the BCBS. While OTS is an active participant both domestically and internationally (including on numerous international subcommittees) in the Basel II process, we remain the only U.S. banking agency without formal representation on the BCBS. This anomaly is more glaring given that OTS is currently the only U.S. regulator to have been accorded "equivalency" status by the European Commission under the European Union's financial conglomerates directive.

I appreciate the opportunity to testify today about the application of the Basel II capital framework in the United States (or, more formally, the International Convergence of Capital Measurement and Capital Standards: a Revised Framework). It was two years ago that OTS was last here to talk about Basel II. Although we are more than two years from its projected implementation, now is a good time to provide an update on the approach to capital contemplated

by Basel II and the status of regulatory convergence, as well as the issues that U.S. financial institutions are expected to face under the Basel II framework.

II. Overview and Background of the Basel Process

A. Basel I

Before discussing where we are today, it is instructive to review the Basel I Accord to provide a background for understanding Basel II.

Basel I, agreed to and issues by the BCBS in 1988, was a set of capital principles designed to strengthen capital levels at large internationally active banks, and foster international consistency and coordination.[1] Basel I addressed only the largest, internationally active banks in G-10 countries and encouraged countries outside the G-10 to adopt the principles for their banks that were operating internationally. The themes of Basel I, however, were intended to apply to all banking organizations of any size and activity.

While OTS did not participate in developing Basel I, we applied it to the institutions we regulate, as did the other three federal banking agencies (FBAs)—the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC). Throughout the implementation of Basel I, the four FBAs developed risk-based capital standards consistent with the 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. 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. The international agreement (framework or mid-year text) articulating these Basel II principles was issued in June 2004.

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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."

B. Basel II

OTS supports the concepts, principles, and stated goals of Basel II, and we are committed to implementing a prudent and sensible framework for its implementation in the United States. Although the BCBS developed a far more detailed and risk-sensitive capital adequacy framework in Basel II than in the original Basel I principles-based accord, it did not stray from the original Basel I objectives. In fact, the BCBS expanded upon these objectives as a guide to its efforts in producing the current proposal. In particular, the BCBS observed that Basel II should:

- Continue to promote safety and soundness and at least maintain the current overall level of capital in the system;
- Continue to enhance competitive equality;
- Establish a more comprehensive approach to address risk;
- Contain approaches to capital adequacy that are appropriately sensitive to risk; and
- Focus on internationally active banks, although its underlying principles should be suitable for application to all banking organizations.

These goals continue to guide the Basel II process both domestically and internationally.

There are many reasons our U.S. banking system should move forward to a more logical, risk-based framework for evaluating capital adequacy in those institutions that would be bound by Basel II, as well as those that choose to opt into it. At the same time, it is important to identify ways to improve Basel I for the thousands of institutions that will not be required to adopt and will not choose to 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.

As you are aware, the international effort on Basel II has been extensive. The June 2004 mid-year text provides for a comprehensive framework for the convergence of national rule-making efforts and approval processes to continue in participating countries, and for banking organizations to complete their preparations for Basel II implementation.

Basel II encompasses three Pillars—minimum regulatory capital requirements (Pillar 1), supervisory review (Pillar 2), and market discipline (Pillar

3). Under Pillar 1's proposed new minimum regulatory capital requirements, institutions must calculate capital requirements for exposure to both credit and operational risk. This is a fundamental change from Basel I, which effectively aggregated all types of risk into a simple "four-bucket" approach that applied a one-size-fits-all "risk-weighting" to assets in each bucket.[2]

The Basel II international framework evaluates various risk types separately, and each risk type may be measured by different methods. In many other countries, credit risk will be measured by either a standardized approach or one of two internal ratings-based approaches under the framework. The two ratings-based approaches, which involve the development of individualized models at each institution, are the Advanced Internal Ratings-Based (AIRB) approach and the "Foundation" approach. Similarly, the centerpiece of the operational risk component also permits use of an internal model, the Advanced Measurement Approach (AMA). There are also other simpler approaches to measuring operational risk under the international framework.

Early in the domestic Basel II process on Pillar 1, decisions were made to adopt in the United States only the AIRB approach for credit risk and the AMA approach for measuring operational risk. Proposals to date have required institutions with more than $250 billion in assets or $10 billion in foreign exposures to adopt these advanced Basel II approaches. Other financial qualifying institutions may elect to adopt the framework at their discretion.

Basel II's supervisory review under Pillar 2 is designed as a way for banking supervisors to attain better overall risk management and internal controls at the institutions we regulate. This includes supervisory review of an institution's own assessment of its capital adequacy positions relative to overall risk, rather than solely of the minimum capital requirements under Pillar 1. Risks not explicitly accounted for under Pillar 1, such as interest rate risk, credit risk concentration, and strategic risks, are dealt with under Pillar 2.

Pillar 3, Basel II's market discipline component, imposes public disclosure requirements on institutions. These are intended to allow market participants to better assess key information about an institution's risk profile and level of capital. The public disclosure requirements are aimed at creating transparency regarding risks undertaken by financial institutions, thus, creating a robust market-based discipline.

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[2] Under Basel I, assets are accorded a zero, 20 percent, 50 percent, or 100 percent risk-weighting depending on their relative risk within predetermined asset categories.

There have also been a series of structured and coordinated information gathering exercises conducted internationally—Quantitative Impact Studies (QIS). These data collections, including QIS 1, 2, 2.5 and 3, have all been conducted in a collaborative framework with results shared by the individual BCBS participants. For example, in 2001, the BCBS conducted two data collection exercises, QIS 2 and QIS 2.5, to gather information to assess whether the BCBS had met its articulated Basel II goals. These studies gathered data from a wide range of banks in the G-10 and beyond to examine the differing risk profiles of banks and the extent to which credit risk mitigation is utilized. Similarly, in October 2002, the BCBS launched another comprehensive field test, QIS 3, that focused on the impact of the Basel II proposals on banks' minimum capital requirements.

One of the subjects of today's hearing, QIS 4, was not a collaborative international effort, but largely a U.S. exercise (with limited international participation) to estimate the proper calibration of Basel II minimum capital requirements for U.S.-based Basel II implementers. QIS 4 involved field tests based on the revised framework set forth in the 2004 mid-year text. In addition, it involved the first attempt by the FBAs to collect data based on the most comprehensive guidance and instructions for the implementation of Basel II in the United States available to date.

As recently reported, the QIS 4 survey showed a wide variation in required capital. Chief among these was a significant capital reduction from the application of Basel II to mortgage lenders, accompanied by significantly increased minimum capital requirements for institutions concentrating in lending activities having significantly higher inherent credit risks. While the wide range of divergence was not expected, the fact that mortgage lending is generally a safer proposition than higher credit risk lending activities should not be surprising—particularly since QIS 4 was an exercise in measuring credit risk.

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. Finally, the underlying collateral of the real property on which they lend secures mortgage lenders. A reduction in the capital requirement for only the credit risk of mortgages was not, therefore, a total surprise.

C. Basel II in the United States

1. Interagency Efforts So Far

The four FBAs have been working with the banking and thrift industry to implement Basel II based on a relatively aggressive timeframe. While some may suggest that we have been at this for a long time, the reality of the Basel II process is that there has been substantial time dedicated by the FBAs to Basel II policy development, but comparatively much less time spent, so far, on Basel II implementation issues.

Under the currently proposed timeframes, a non-binding "parallel run" of the Basel II framework is projected to begin in 2007, with full implementation targeted for 2008. During the parallel run phase, institutions seeking to implement the Basel II framework would also be required to continue to comply with the existing Basel I requirements.

In an effort to meet the proposed timeframes, the FBAs have cooperated on several joint interagency efforts. These include various issuances to implement the Basel II framework domestically, including guidance to assist financial institutions in developing systems and processes to perform the numerous, highly complex calculations required under the Basel II framework.

In August 2003, the FBAs published a notice and request for comment on several pieces of supervisory guidance addressing corporate lending activities—"Draft Supervisory Guidance on Internal Ratings-Based Systems for Corporate Credit" and "Supervisory Guidance on Operational Risk Advanced Measurements Approaches for Regulatory Capital." Accompanying these was an Advanced Notice of Proposed Rulemaking (ANPR) proposing the adoption of the AIRB approach for measuring credit risk and the AMA approach for measuring operational risk (see above discussion under "Basel II"). Significantly, the ANPR did not include provisions for adopting the standardized or foundation approaches outlined in the Basel II framework.

In October 2004, the FBAs published for notice and comment supervisory guidance on retail lending programs—"Internal Ratings Based Systems for Retail Credit." Standards set forth in this and the previously issued guidance are being updated and expanded to address issues raised in industry and public comments.

On January 27, 2005, the FBAs issued an interagency statement addressing U.S. implementation of the Basel II framework and the qualification process for the AIRB approaches to credit risk and operational risk. Pursuant to that

guidance, U.S. institutions planning to adopt the Basel II framework are encouraged to prepare implementation plans, including a self-assessment and identification of areas that require additional work.

Most recently, in April 2005, an international proposal was issued covering certain trading-related exposures and double default effects. Comments on the proposal are due the end of May. Pending the outcome of comments received on the proposal, the FBAs anticipate incorporating the internationally agreed upon principles into the proposed domestic regulations.

2. Interagency Efforts Going Forward

a. The NPR

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. While the domestic timeline anticipated publication of a NPR sometime in mid-2005, this is being reassessed pending a thorough analysis of the QIS 4 data. At present, the FBAs are still working toward issuance of a final rule in mid-2006, which is a critical timing issue for U.S. financial institutions to have sufficient lead-time to prepare for the parallel run that is scheduled to begin in 2007. This, of course, is contingent on satisfactory resolution of the QIS 4 issues.

It is also important to note that OTS and OCC are subject to Executive Order 12866, which requires executive agencies to determinate whether a proposed rule is a "significant regulatory action." OTS has determined that the NPR will by 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 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. Anticipated Supervisory Guidance

In conjunction with issuance of an NPR, the FBAs also plan to issue proposed guidance consolidating the previously issued guidance on retail, corporate and operational risk. The consolidated guidance is expected to include issues not previously addressed, including securitization, credit risk mitigation, equity exposures and various wholesale transactions, such as repurchase agreements. Industry reaction and comment on the consolidated supervisory

guidance will be critical since it will be the first iteration of U.S. regulatory policy on some subjects. In addition, it will be the first opportunity for the industry to judge 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 the final rule.

c. Basel I Rewrite

In recognition of the enhancement of risk measurement tools since the enactment of Basel I, OTS has been a strong advocate of revising and modernizing the existing Basel I domestic capital standards. Our view is that the revision of Basel I should encompass meaningful reforms, but avoid imposing costly analytical processes on smaller banks and thrifts. For example, modifying the existing rule with more accurate risk-weights allocated to a wider range of asset buckets would substantially improve the current Basel I framework. Applying commonly used risk criteria for identifying different levels of risk would further enhance the existing framework. This would provide for a more granular, risk-sensitive system of determining appropriate levels of capital. We strongly support amending the existing domestic Basel I regulations simultaneously, or in close proximity to, rulemaking efforts implementing Basel II. It may also be worthwhile to explore amending Basel I sooner, particularly if Basel II timeframes are pushed back.

d. The QIS 4 Survey

In the midst of ongoing development of U.S. implementation of the AIRB approach for Basel II, the FBAs met in the spring of 2004 to design the basic data forms, as well as instructions and questionnaires, for QIS 4. As a participant in this process, OTS focused particularly on the impact on mortgage lending, the predominant activity of the thrift industry,[3] and on gathering data on home equity lines of credit, a significant growth area for banks and thrifts.[4] It appears from the preliminary data that our interest in adding a separate section for home equity lines of credit to the survey was warranted.

On June 26, 2004, the FBAs issued a press statement outlining the objectives and timing of QIS 4 and inviting institutions interested in participating

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[3] Significantly, mortgages and mortgage-backed securities currently constitute over 34 percent of assets of the entire banking industry.

[4] Home equity lending for the banking and thrift industry currently stands at roughly $491 billion, exceeding the industry's on-balance-sheet credit card assets by more than 22 percent.

in the survey to express that interest to their supervisor. The initial response to this solicitation included a broad range of institutions, from small regional banks that wanted to learn more about Basel II, to the largest and most sophisticated internationally active banks expected to implement Basel II.

On October 29, 2004, the FBAs released the QIS 4 instructions, questionnaire, and a preliminary workbook with numerous tabs for data on each of the primary asset categories covered under Basel II. As the questionnaire noted, the agencies recognized that the data and systems relevant to AIRB would still be in development at many institutions, and understood that institutions, whatever their preparation, would be assembling estimates on a best efforts basis.

Twenty-seven institutions provided survey responses. One institution supplied only its operational risk capital requirement, and thus is not included in the summary data. The FBAs had subsequent conversations with the participants, primarily to address internal inconsistencies in the data. Many respondents resubmitted their data, making some minor and often major changes, a process that continues.

III. Issues Raised by QIS 4

As previously highlighted, based on a preliminary analysis of the QIS 4 data, there appears to be substantial variation in the respondents' Basel II capital results. The results of the QIS 4 exercise suggest that Basel II is very much a work in progress in the United States, both for the FBAs and the institutions that will implement it. It is entirely appropriate at this juncture to ask whether we may be moving too quickly and, if so, to reassess and determine how to adjust the timelines we have been operating under to implement Basel II.

Taking into account the substantial cautions about interpreting the QIS 4 survey results, the aggregate data show a significant decrease in the amount of capital required for credit risks associated with all but one category of wholesale and retail lending, including large capital reductions for mortgage and home equity lending.[5] This is an especially important result because of commercial banks' concentration in mortgage-related assets.[6]

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[5] Based on the preliminary results of QIS 4, required minimum capital for wholesale credit categories dropped an average of 23.7 percent, including a more than 41 percent reduction for income producing real estate. Similarly, required minimum capital for retail credit categories declined an average 26.9 percent, with a 75 percent reduction for home equity lending, but with a 60 percent increase in required minimum capital for credit card lending activities. See attached survey results.

[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

It is important to note that mortgage lending typically includes a significant degree of interest rate risk. This is a critical element in evaluating appropriate capital levels even under Basel II; however, interest rate risk was not addressed in the QIS 4 survey. The survey only addresses the credit risk component of the mortgage capital requirement. For prime mortgages, credit risk is generally fairly low. Thus, the declines in capital for mortgages measured by QIS 4 most likely result from the low credit risk of various individual mortgage portfolio lenders that participated in the survey. We cannot confirm this, however, absent further analysis.

In recognition of the substantial interest rate risk associated with many forms of mortgage lending, OTS has developed a rigorous interest rate risk model. The model requires an institution to hold sufficient capital—depending on the degree of its exposure to potential interest rate shifts—to offset interest rate risk exposure.[7] It is our experience, working with our interest rate risk model for more than a decade, that savings associations have modified interest rate risk-taking behavior based on information and tools provided by the model. How interest rate risk is ultimately treated under Basel II is an important issue for OTS and the thrift industry, as well as banks that focus on mortgage lending activities.

Another noteworthy result from QIS 4 is 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 325 percent, to $491 billion. This is due, in large part, to the low interest rate environment that we have experienced recently for mortgages and mortgage-related products. The aggregate survey results may well reflect just the most recent experience, and not the full economic cycle risk parameters required under Basel II.

In fact, we are very concerned that the imbedded potential risks of home equity lending exceed what the results from the last few years have shown. As a

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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.

7 OTS's interest rate risk model assesses the portfolio interest rate risk exposure at a given institution and provides a report to the institution and to OTS examiners. Where there is too much interest rate sensitivity in the portfolio relative to the market value of portfolio equity, an OTS examiner will work with the institution to develop strategies to mitigate the risk. These include better matching of the effective durations of assets and liabilities, interest rate hedging strategies, reducing portfolio leverage, or a combination of these. To date, the OTS model has been reasonably effective in controlling interest rate risk at the institutions we regulate.

result, we are currently working with the other FBAs on additional interagency supervisory guidance on home equity lending.

The QIS 4 survey has also demonstrated that the banking industry is in various stages of preparedness in implementing an AIRB approach to capital. This is to be expected, particularly since the FBAs are also in the process of developing and articulating guidance on what the AIRB approach means to institutions from a regulatory perspective as well as how institutions should proceed to implement it. The difficulty of this process is that it is very much interdependent and, ultimately, requires data to validate the underlying assumptions as well as to make the necessary adjustments to implement a workable model. That is, institutions' ability to validate their risk management processes and the FBAs' ability to supervise them depends greatly on developing rich and robust data.

Given what we have learned so far from the QIS 4 exercise, prudential supervision suggests that a longer implementation period is needed to gain the necessary data and confidence we require before implementing such a major change in our capital framework. It is also important that we continue to move forward to attempt to remain abreast of our international supervisory counterparts. This is a difficult challenge, but OTS remains committed to working with the other FBAs on the Basel II process with a goal of timely implementation of a sound capital framework—for the Basel II implementers as well as the vast majority of institutions that will continue to operate under Basel I, albeit with substantial improvements from the Basel I rewrite process. We urge institutions to continue to develop their internal risk systems and data gathering efforts, and ask the patience and support of Congress and the industry to assist us in this difficult, but worthwhile, challenge.

IV. Public Policy Concerns with Basel II

A. Timing

Although refining our risk measurement and management systems by implementing a more risk sensitive capital framework is an important objective, we must do so mindful of a broader public policy context. Longstanding capital adequacy standards combined with a well-established and highly respected supervisory structure that includes regular on-site examinations have delivered a banking system that is healthy and robust. While OTS supports the Basel II effort, we do so with an equally important objective of doing no harm to our existing banking system.

Improved risk monitoring technologies available to institutions have propelled advancements in capital requirements and dramatically improved capital allocation efficiencies. Moving to a more advanced and risk sensitive capital framework is necessary in order to take full advantage of advanced risk measurement techniques. It is important to approach this exercise cautiously and systematically in order to provide for sufficient time to study and debate the best course of action in the United States for implementing the complexities of the advanced models-based capital system of Basel II.

The movement to Basel II currently contemplated for our largest and most sophisticated institutions is a dramatic paradigm shift from the current principles-based Basel I risk buckets. Ideally, this should be an evolutionary process that provides ample time for policy development, real-world testing, and the gradual migration of institutions to the new system based on their demonstrated readiness. Developing a capital system that encourages better risk measurement and management practices is, of course, the required first step in this process, but the lure of "big thinking" should not overwhelm practical considerations of "how will this really work." Most importantly, institutions should not be permitted to adopt any new capital framework absent clear evidence that they are ready to do so.

While we would like to have had the benefit of experience afforded by other interim approaches to improved capital risk measurement and management, those options may no longer be available if we are to remain in sync with international Basel II implementation. Significant uncertainty is inherent in the most advanced approaches of Basel II, as well as with the uneven state of readiness at our largest banking organizations—and the regulatory and supervisory framework we have developed for them.

At this time, all agree that there is much to be done before the advanced approaches of Basel II can be adopted in the United States. The FBAs must minimize significant unintended consequences and—with the stakes so high—it is far better to get it right than to get it done in some arbitrarily set timeframe. We believe that, as a matter of good public policy, the Basel II timeframes should be viewed as guidelines, not hard targets. It is our intent to pursue Basel II implementation in the United States with this notion firmly guiding our future actions.

B. Competitive Considerations

The goal of more risk-sensitive capital requirements is as important for small community banks as it is for large, internationally active institutions. Achieving greater risk sensitivity for one part of the banking system and not the

whole will invariably create competitive distortions. While the ideal of global regulatory convergence of capital standards is extremely important, we must not ignore its effects and potential impact on U.S.-based institutions that are not operating internationally.

At issue is whether we maintain comparable (although not necessarily identical) capital standards for all banking 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 by being left behind, mired in the relatively risk-insensitive Basel I system. Competitiveness issues raised by Basel II necessitate an across-the-board examination of capital standards for all our banks and thrifts. This provides an opportunity to re-examine the appropriateness of the Basel I risk-based capital system for our community institutions, and to take the necessary steps to reduce potential competitive inequities.

OTS is pleased that an initiative we have advocated for years, the so-called Basel IA rewrite, has ripened into a commitment by all the FBAs to propose modifications to Basel I for U.S. banking organizations that do not adopt Basel II. The goal of this initiative is to achieve greater risk-sensitivity without undue complexity. We believe this can be accomplished by increasing the available asset "risk-buckets," and by applying commonly understood criteria for assessing the relative risk of various loan types. In hindsight, perhaps it would have been productive to pursue this strategy for all U.S. institutions some time ago. Modifying Basel I in this manner may have provided a useful interim step along the road to Basel II, and relieved some of the current time pressure on implementing the models-based approaches of Basel II.

C. Interest Rate Risk

As previously described, Basel II includes minimum regulatory capital requirements under Pillar 1 that require institutions to calculate capital requirements for exposure to credit and operational risk. Pillar 1 does not, however, include specific capital requirements for interest rate risk. The framework addresses interest rate risk as part of market risk in Pillar 2. OTS believes that this significant risk, especially important in mortgage products, should be addressed by the FBAs consistently. If the FBAs adopt final regulations maintaining this Pillar 2 construct for interest rate risk, it will be important to study this issue carefully and prepare comprehensive interagency guidance on how we expect this risk to be measured and managed.

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

Any discussion of Basel II is incomplete without a discussion of the interrelationship between leverage and risk-based requirements. Unfortunately, the issue has spawned a substantial amount of dialogue about whether there should be a leverage requirement. No one seriously disputes this notion.

While 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, the principal objective of a leverage requirement is different. Fundamentally a backstop to protect the federal deposit insurance funds, the leverage requirement places a constraint on the maximum degree to which a banking organization can leverage its equity capital base.

In the late 1980's, Prompt Corrective Action (PCA) was instituted in response to the need for more aggressive and timely supervisory intervention in the face of stressed and declining capital levels. Currently, the FBAs define a "well-capitalized" institution as having Tier 1 (i.e., core) 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.

Bearing in mind that these are institution-wide levels (as opposed to the asset segment measurements of risk as prescribed by Basel II), the potential conflict with Basel II is readily apparent. If one believes that Basel II will achieve greater risk sensitivity, then an institution with a concentration of low risk assets will be constrained by the leverage ratio, and its capital will not be risk sensitive. Conversely, leverage may impose no restraint on a relatively high risk institution, but that institution would be constrained, presumably, by an effective risk-sensitive standard.

The current one-size-fits-all approach to a leverage ratio runs at cross-purposes with Basel II. Leverage treats all assets on the balance sheet identically. It provides too little incentive to manage risk for both very low and very high credit risk institutions. In a more complex financial world than was envisioned in the 1980's, today's expanding universe of off-balance-sheet activity goes untouched by existing leverage requirements. Thus, a regulatory capital system with a risk-insensitive leverage ratio that becomes the principal binding capital constraint on financial institutions, rather than a backstop measure, would be significantly flawed. Furthermore, such a system may perversely motivate low

credit risk lenders to pursue riskier lending—one of the unintended consequences mentioned earlier.

OTS remains committed to defining an appropriate leverage ratio for all types of lenders. It is important for the FBAs to retain the broad authority granted through PCA to move swiftly and effectively when banking organizations approach distressed capital levels. We take issue, however, with those who argue that this leverage ratio is inviolate for healthy and robust institutions, with superior risk measurement and management.

As a regulator, it is easy to ask for more capital through a simple construct. It is harder to harmonize leverage, PCA and risk-based concepts in an increasingly complex system, maintaining the vitality of the safety and soundness goals of both, without unduly burdening healthy banks and thrifts. Ideally, the requirements should work in unison. As we progress in improving our risk-based capital system, for all our banking organizations, it is incumbent upon us to pay close attention to its ongoing relationship with our leverage requirements.

No capital approach is, by itself, an adequate answer to ensuring safety and soundness. Similarly, layering in a variety of permanent counter measures, such as arbitrary floors and multipliers, into the Basel II capital requirements to offset capital reductions in low credit risk portfolios, undermines the overarching goal of creating a more risk-sensitive framework. It is important to get each facet of our capital regime right, and that may take more time and more commitment to those purposes.

V. Issues for Further Consideration

Numerous issues raised by QIS 4 require us to take sufficient time to complete a thorough analysis of its results. The potential impact of Basel II on our banking system requires us to move forward at a measured pace and not sacrifice accuracy for speed.

Among the issues for consideration are whether Basel II should be modified to allow for other available options, including the creation of transitional steps before proceeding to full Basel II implementation. This includes preserving flexibility to change existing timeframes to allow for supervisory qualification and validation, and to permit institutions more time to operate under parallel standards as well as to implement Basel II at their own pace.

Completing the Basel I rewrite should also proceed in a timely manner, even if it outpaces work on Basel II; although we believe that, for competitive

reasons, the Basel I rewrite should not fall behind the pace of the Basel II process. Like the Basel II process, the Basel I rewrite should proceed at a pace that ensures success in designing a sound capital system that can be sustained and improved upon as necessary in the future.

Another important, if not critical, consideration is addressing the leverage requirement and the Basel II floors as a complete, seamless and integrated framework in the United States. In this regard, we may also want to consider addressing interest rate risk in Pillar 1, rather than retaining it in Pillar 2.

The course of our deliberations on all these issues should continue to be guided by the important goals of Basel II, including updating and modernizing U.S. capital standards in support of global convergence and to encourage better risk management, improved safety and soundness, and greater efficiency and competitiveness.

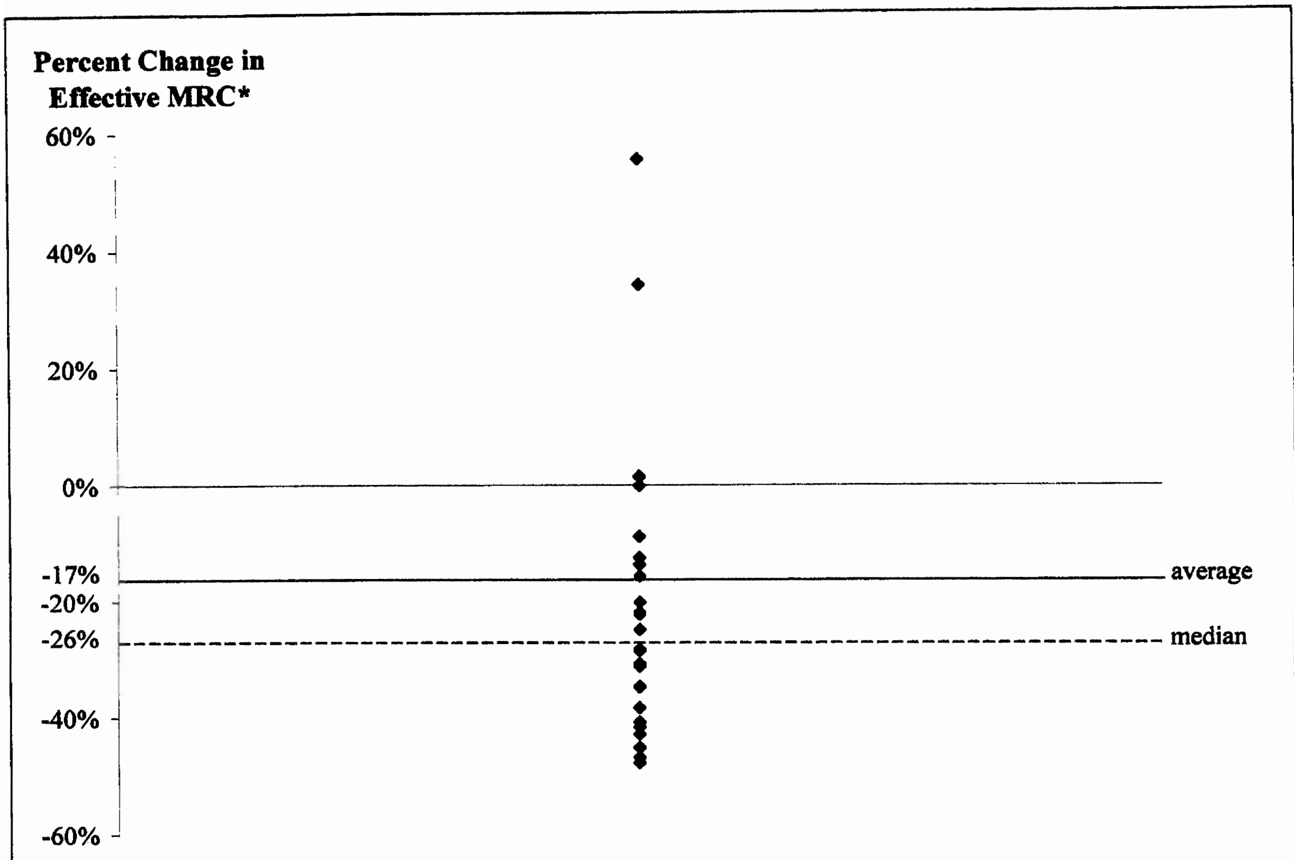
VI. Conclusion

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 deliberative manner. We should also be prepared to take any steps necessary to accomplish the goals of Basel II, even if that means delaying implementation of the new framework.

It is critical that all interested parties, including the industry, Congress and the regulators, continue an active, open and thorough dialogue regarding the issues and timing of Basel II. We will continue to work together with Congress, the other FBAs, and with our BCBS colleagues in the international community to ensure that we get Basel II right, as opposed to just "on time."

Thank you, Chairman Bachus and Chairman Pryce for holding this important hearing, and for the continued interest and hard work of the Members 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.

Preliminary Change in Effective Minimum Capital Requirements of Participating Institutions: Basel I to Basel II



*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is preliminary data as of May 5, 2005 for the twenty-six participating QIS-4 institutions; caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies plan additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.

Preliminary Change in Minimum Capital Requirements of Participating Institutions: Basel I to Basel II

Portfolio	% Change in Portfolio MRC	Median % Change in Port. MRC	Share of Basel I MRC	Share of Basel II MRC
Wholesale Credit	**(25%)**	**(24%)**	**44.3%**	**38.8%**
Corporate, Bank, Sovereign	(22%)	(30%)	33.9%	30.7%
Small Business	(26%)	(27%)	4.6%	4.0%
High Volatility CRE	(33%)	(23%)	1.8%	1.4%
Incoming Producing RE	(41%)	(52%)	4.0%	2.7%
Retail Credit	**(26%)**	**(50%)**	**30.5%**	**26.3%**
Home Equity (HELOC)	(74%)	(79%)	6.1%	1.8%
Residential Mortgage	(62%)	(73%)	11.1%	4.9%
Credit Card (QRE)	66%	63%	6.1%	11.7%
Other Consumer	(7%)	(35%)	6.0%	6.5%
Retail Business Exposures	(6%)	(29%)	1.2%	1.3%
Equity	11%	(9%)	1.3%	1.6%
Other assets	(12%)	(3%)	10.1%	10.4%
Securitization	(20%)	(40%)	7.9%	7.7%
Operational Risk			**0.0%**	**9.0%**
Trading Book	0%	0%	5.2%	6.0%
Portfolio Total	**(14%)**	**(24%)**	**100.0%**	**100.0%**
Change in Effective MRC*	**(17%)**	**(26%)**		

*This is the change in the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement.

Note:
This is preliminary data as of May 5, 2005 for the twenty-six participating QIS-4 institutions; caution should be used in drawing any inferences from the aggregate data at this stage. The U.S. banking agencies plan additional work to determine whether these results reflect differences in risk, reveal limitations of QIS4, identify variations in the stages of bank implementation efforts (particularly related to data availability), and/or suggest the need for adjustments to the Basel II Framework.