Susan Schmidt Bies: Basel II and commercial real estate

Testimony of Ms Susan Schmidt Bies, Member of the Board of Governors of the US Federal Reserve System, before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, US House of Representatives, Washington, DC, 14 September 2006.

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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.