Susan Schmidt Bies: A risk-management perspective on recent regulatory proposals

Remarks by Ms Susan Schmidt Bies, Member of the Board of Governors of the US Federal Reserve System, at the America's Community Bankers Risk Management and Finance Forum, Naples, Florida, 10 April 2006.

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Thank you for the invitation to speak today. I always find these forums very informative and useful, in part because they keep me apprised of the issues currently on the minds of bankers. And I hope you agree that these conferences are beneficial to the broader dialogue between bankers and regulators. I plan to focus on several issues that I believe are of interest to this group, including commercial real estate, nontraditional residential mortgages, and proposed changes to regulatory capital rules. With these initiatives, supervisors are trying to emphasize our broader goal of improving risk management at banks, while not dictating in which businesses banks should engage or to what extent.

If you look at their balance sheets and income statements, you will see that community banks are thriving. As Federal Reserve Chairman Bernanke noted recently, capital, earnings, and asset quality are improving for banks of all sizes, but particularly for community banks. Nonperforming assets, net charge-offs, and loan-loss provisions for community banks have been at low levels in recent years. And community banks remain profitable. The continuing strength of this part of the financial sector is also visible in supervisory ratings, with the number of problem community banks at historical lows.

But of course all of you know that there are still potential risks on the horizon, and supervisors are paid to make sure that bankers manage those risks properly to maintain the safety and soundness of the banking system. So while the banking industry is doing well of late, we believe there are a few recent regulatory proposals to which bankers--including community bankers--should pay attention.

Commercial real estate

It is perhaps an understatement to say that those gathered here today are aware of the proposed commercial real estate (CRE) guidance recently issued by the U.S. banking agencies. Indeed, we have received hundreds of comment letters on the proposed guidance so far: the comment period ends April 13. I will be honest and say that I have not had a chance to read all of the comments. Naturally, we welcome these comments, since we were looking for extensive feedback when we issued the proposed guidance in the first place.

At this point, I would like to underscore that the proposed guidance is intended to encompass "true" CRE loans. It is not focused on commercial loans for which a bank looks to a borrower's cashflow as the source of repayment and accepts real estate collateral as a secondary source of repayment. That is, the proposed guidance addresses bank lending on commercial real estate projects where repayment is dependent on third party rental income, or the sale, refinancing or permanent financing of the property. These are "true" commercial real estate loans for which repayment depends upon the condition and performance of the real estate market.

I would also like to mention up front that the proposed guidance is not intended to cap or restrict banks' participation in the CRE sector, but rather to remind institutions that proper risk management and appropriate capital are essential elements of a sound CRE lending strategy. In fact, many institutions already have both of these elements in place.

Commercial real estate lending played a central role in the banking problems of the late 1980s and early 1990s and has historically been a highly volatile asset class. Past problems in CRE have generally come at times when the broader market encounters difficulties. Therefore, banks should not be surprised by the emphasis of the proposed CRE guidance on the importance of portfolio risk management and concentrations. One reason why supervisors are proposing CRE guidance at this point is that we are seeing high and rising concentrations of CRE loans relative to capital. For certain groups of banks, such as those with assets between $100 million and $1 billion, average CRE concentrations are about 300 percent of total capital. This compares to a concentration level of about 150 percent in the late 1980s and early 1990s for this same bank group.

While banks' underwriting standards are now generally stronger than in the 1980s and 1990s, the agencies are proposing the guidance now to reinforce sound portfolio-management principles that a bank should have in place when pursuing a commercial real estate lending strategy. A bank should both be monitoring the performance on an individual loan basis as well as on a collective basis for loans collateralized by similar property types or in the same markets. When a bank targets commercial real estate lending as a primary business activity, it needs to consider that the risk exposure to the performance of its total CRE loan portfolio--the concentration risk--depends upon broader real estate market conditions. For example, if a bank has several borrowers with similar projects that encounter problems--such as longer absorption periods, higher marketing costs, or higher vacancy rates--weaknesses in the broader real estate market can have a cascading effect on the quality of a bank's CRE portfolio as real estate values erode.

Some institutions' strategic- and capital-planning processes may not adequately acknowledge the risks from their CRE concentrations. This is particularly important, since CRE lending in recent years has occurred under fairly benign credit conditions and, naturally, those conditions are unlikely to continue indefinitely. The ability of banks with significant concentrations to weather difficult market conditions will depend heavily on their risk management processes and the level of capitalization. From a risk-management and capital perspective, institutions generally should focus on the emerging conditions in their real estate markets, the potential cumulative impact on their portfolios if conditions deteriorate, and significantly employ other exercises to help identify CRE vulnerabilities. Of course, such exercises should vary according to the size of the organization and the level of the concentration. All of these are key elements of a sound strategy to manage concentrations.

In evaluating the impact of their CRE concentrations, bankers should also pay attention to geographic factors. Many banks conduct successful CRE lending within a certain geographic area, but problems can arise when banks begin to lend outside their market or "footprint" for which they normally have better market intelligence. In recent years, supervisors have observed banks lending outside their established footprint, to maintain a customer relationship, into real estate markets with which they have less experience. The challenge is heightened when the borrower is also venturing into a new market. These practices led to significant losses in prior CRE credit downturns.

I noted that CRE underwriting appears substantially better compared to the late 1980s and early 1990s. However, we have noticed some recent slippage. Therefore, the proposed CRE guidance underscores the existing interagency guidance on real estate lending standards. That is, it offers some reminders about risk-management practices for individual exposures. In order to attract new business and sustain loan volume, banks may occasionally be inclined to make some compromises and concessions to borrowers. As supervisors, we want to ensure that loan-to-value standards and debt-service-coverage ratios are meeting the organization's policies--and that there is not an undue increase in the exceptions to those standards and ratios. We also continue to monitor whether lenders routinely adjust covenants, lengthen maturities, or reduce collateral requirements. To be clear, we have not yet seen underwriting standards fall to unsatisfactory levels on a broad scale, but we are concerned about some of the downward trend in these standards.

Furthermore, no element of the proposed guidance is intended to act as a "trigger" or "hard limit" for immediate cutback or reversal of CRE lending; rather, it should be viewed as a reminder to institutions that certain risk management standards are vitally important for banks involved in the business. Additionally, if the agencies finalize the proposed guidance, they intend to use the proposed thresholds in the guidance only as a "first cut" or "screen" to identify institutions that may have heightened CRE concentration risk. The thresholds are intended to serve as benchmarks to identify cases for further review. In some cases, supervisors, after more careful review, may actually find that given the characteristics of its CRE portfolio, an institution has sound risk management and is holding appropriate capital. In general, the proposed guidance is intended to be applied quite flexibly and in a manner consistent with the size and complexity of each organization.

Nontraditional residential mortgages

You are probably also aware that the U.S. banking agencies recently issued proposed supervisory guidance on nontraditional mortgages, for which the comment period ended March 29. We appreciate the extensive feedback from the industry and others. The agencies are now in the process of reviewing the comment letters and deciding on a way forward. While the main focus of the proposed guidance is on banks' ability to adequately identify, measure, monitor, and control the risk associated with these products, the proposed guidance also addresses consumer protection, which is what I would like to focus on today.

As outlined in our proposed guidance, nontraditional mortgages contain aspects of complexity, which could make it difficult for consumers to understand all the possible consequences of borrowing. In general, bankers need to be especially alert to developing easily understood disclosures as they introduce more innovative and complex products, and as they market them to broader customer segments rather than the original niche customer. The elements relating to consumer protection in the proposed nontraditional mortgage guidance are included because we think addressing these issues is consistent with good risk management.

Nontraditional mortgages typically allow borrowers to defer payment of principal and, sometimes, interest. These products include interest-only mortgages and payment option adjustable-rate mortgages (or ARMs), which have been available for many years. They have recently become increasingly popular, often combined with practices such as reduced documentation of income and assets in evaluating applicants' creditworthiness.

Although these products can be beneficial for some borrowers, today these products are being offered to a wider spectrum of consumers. Some of these consumers may not understand the associated risks. For example, there could be a substantial increase in the monthly payment, or "payment shock" that could occur when the loan's interest rate increases after a low "teaser-rate" period and if the market interest rate index rises through the term of the loan. In addition, consumers may not be aware that payments can increase considerably when a loan begins to fully amortize after an interest-only period. They also may not understand the full impact of negative amortization, including the fact that they may be repaying more than they initially borrowed.

The Board's Truth in Lending regulations require creditors to provide consumers with disclosures about the loan terms, including a schedule of payments. For interest-only and payment option ARMs, the payment schedule shows consumers how their payments will increase to include amortization of the principal. The proposed interagency guidance includes recommended practices that describe how institutions can use their promotional materials to provide information about the features and risks of these products, especially the risk of payment shock. For example, the guidance recommends that institutions inform consumers about the maximum monthly payment they could be required to pay once interest rate caps and negative-amortization caps have been reached. The proposed guidance also lists recommended practices to address other risks. When negative amortization is possible, the guidance suggests that institutions alert consumers about the consequences of increasing principal balances and decreasing home equity. If both reduced- and full-documentation loan programs are offered, the draft guidance advises institutions to inform consumers if they will pay a pricing premium for the reduced-documentation loan. When institutions provide monthly statements with payment options, they are urged to include information that enables borrowers to make well-informed choices--information that explains each payment option and the impact of each choice.

The draft guidance also urges institutions to ensure that their advertisements, promotional materials, and oral communications are consistent with the product terms and that these communications provide clear, balanced, and timely information to consumers about the risks. This is important so that consumers have the information they need at critical decision times, such as when selecting a loan product or choosing a specific payment option each month. In general, bankers should ensure that borrowers are aware of the range of outcomes with a nontraditional mortgage.

Proposed revisions to regulatory capital rules

By now you have probably heard the news that the Federal Reserve Board reviewed and, in an open Board meeting on March 30, approved a draft of the interagency notice of proposed rulemaking (NPR) on the Basel II capital framework, seeking comment on that draft. The draft NPR and some statements made at the public meeting are now available on the Board's web site. The NPR is expected to be issued in the Federal Register once all of the U.S. banking agencies have completed their respective review and approval processes, at which time it will then be "officially" out for comment. That should all happen in the next few months.

We are very pleased that the substantial time spent on the Basel II effort has culminated in this important achievement. We also recognize the significance of the NPR to the industry, Congress, and others who have waited for more detail on the proposed rulemaking. We look forward to receiving comments on the NPR; they will contribute to our assessment of Basel II objectives and help us determine whether the NPR in fact produces a prudent, risk-sensitive regulatory capital regime. In some areas, the agencies are still grappling with the correct approach. For this reason, the NPR contains a number of requests for feedback on specific topics. All of this will help us as we continue to develop the framework. But before commenting further on the NPR and the U.S. Basel II process, I would like to reiterate our rationale for pursuing Basel II.

Basel II proposals

The current Basel I capital framework, adopted nearly twenty years ago, has served us well. For the vast majority of U.S. banks, Basel I continues to provide a useful measure of regulatory capital, while not being particularly burdensome. However, Basel I has become increasingly inadequate for large, internationally active banks that are offering ever more complex and sophisticated products and services. In other words, the current Basel I capital requirements have over the past decade begun to deviate substantially from the risk profiles of large, complex organizations. We need a better capital framework for these large, internationally active banks, and we believe that Basel II is such a framework. And from a financial stability perspective it is in everyone's interest to have regulatory capital measures at large, complex banks more accurately reflect their actual risks.

One of the major improvements in Basel II is the closer linking of capital requirements and risk. The current Basel I measures are not very risk-sensitive and do not provide bankers, supervisors, or the marketplace with meaningful measures of risk at large, complex organizations. Under Basel I, it is possible for two banks, with dramatically different risk profiles in their commercial loan portfolios, to have the same regulatory capital requirement. And under Basel I, a bank's capital requirement does not reflect deterioration in asset quality. Moreover, the balance-sheet focus of Basel I does not adequately capture risks of certain off-balance-sheet transactions and fee-based activities--for example, the operational risk embedded in many of the services from which many large U.S. institutions generate a growing portion of their revenues. For large, complex banks, the costs of mismeasuring regulatory capital requirements are much higher and, therefore, there is a greater need to amend the rules for these institutions--this need is the impetus for Basel II.

In addition to making regulatory capital measures more meaningful, Basel II should make the financial system safer by substantially improving risk management at banks. Basel II builds on the existing risk-management approaches of well-managed banks and creates incentives for banks to move toward leading-edge risk-measurement and risk-management practices. By providing a consistent framework for all banks to use, supervisors will be better able to identify banks whose risk management and risk levels differ significantly from other banks. By communicating these differences to banks, management will be able to benchmark their risk assessments, models, and processes in a more detailed and regular manner. We have already seen some progress in risk management at many institutions in the United States and around the globe as a result of preparations for Basel II. The new framework is also much more consistent with the internal capital measures that institutions use to manage their business.

I hope it is clear from the NPR and other statements made by the agencies that we are committed to ongoing, detailed analysis to ensure that U.S. implementation of Basel II achieves its goal: establishing a strong and risk-sensitive base of minimum regulatory capital. First of all, the U.S. agencies included in the NPR a proposed timetable and set of transition safeguards that are more rigorous than those set forth in the 2004 Basel II framework. For instance, the U.S. agencies are proposing three transition periods, during which an individual institution's Basel II minimum required capital will not be permitted to fall below certain percentages of its capital requirement under the general risk-based capital rules.

At several points during the transition to Basel II, the agencies intend to conduct thorough analyses of each institution's Basel II capital results and Basel II's impact on aggregate minimum required capital in the U.S. banking system. The U.S. regulators are united in their belief that no bank should be permitted to operate under Basel II until it has proven itself ready to do so. In other words, we plan to have very high standards for Basel II qualification. For instance, a bank will be able to move from the parallel run to the first transitional floor period only after its primary supervisor has given it permission to do so--and only after that supervisor has thoroughly evaluated the bank's risk-management methodologies and its ability to calculate minimum regulatory capital using the new framework. Similarly, a bank will only be allowed to move to each successive floor, as well as to the full Basel II minimum capital calculation without floors, upon a finding by the primary supervisor that it is ready, following a rigorous qualification process.

To reiterate, during *and* after the transition to Basel II, supervisors plan to rely on ongoing, detailed analyses to continuously evaluate the results of the new framework and ensure prudent levels of capital. And to be quite clear, the Federal Reserve believes that strong capital is critical to the health of our banking system. We also believe that Basel II will help us continue to ensure that U.S. banks maintain capital levels that serve as an appropriate cushion against unexpected losses.

As we have mentioned before, we will continue to use existing prudential measures to complement Basel II. For example, the current leverage ratio requirement--a ratio of capital to total assets--will remain unchanged for all banks, whether or not they are subject to the Basel II framework. Also, supervisors will continue to enforce existing prompt-corrective-action rules in response to declines in capital. Both the leverage ratio and prompt-corrective-action rules are fully consistent with Basel II.

Proposals to amend Basel I

Of course, those of you here today have also been following discussions about possible changes--beyond Basel II--to the existing regulatory capital rules. First of all, we expect only one or two dozen banks to move to Basel II in the near term. The vast majority of U.S. banks would be able to continue operating safely under Basel I as amended through the rulemaking process. The Basel I framework has already been amended more than twenty-five times in response to changes in the banking environment and a better understanding of the risks of individual products and services. The agencies believe that now is another appropriate time to amend the Basel I rules.

These proposals to amend Basel I, also known as "Basel IA," are still at an early stage. Last fall, the U.S. banking agencies issued an advance notice of proposed rulemaking (ANPR) that outlined suggested Basel I changes. In part, these proposed changes are meant to address concerns about the potential adverse competitive effects of Basel II.

We take concerns about competitive effects seriously. During the Basel I ANPR process, we sought input from the industry and other interested parties. The Federal Reserve has conducted substantial research about the potential effects of Basel II--published on our web site--and plans to continue those efforts. In an effort to mitigate those concerns, regulators have proposed changes to enhance the risk sensitivity of U.S. Basel I rules; we also remain vigilant about identifying potential competitive distortions that might be created with the introduction of Basel II.

We are also mindful that amendments to Basel I should not be too complex or too burdensome for the multitude of smaller banks to which the revised rules will apply. That is, in Basel I amendments we are trying to find the right balance between added risk sensitivity and low burden. As you are aware, this is not necessarily the easiest balance to find. For example, there may be a desire to tie regulatory capital measures more closely to risk, but only by expanding the use of factors that determine regulatory risk weights. However, if we expand the number of factors that are used--for example, loan-to-value measures, credit scores, and external credit ratings--that will likely increase the burden for calculating regulatory capital. In short, we are faced with a tradeoff. And some of the comment letters received so far address this very point. Naturally, institutions differ with respect to this tradeoff, with some wanting greater risk sensitivity at the cost of greater burden, and some wanting just a little more risk sensitivity with little or no additional burden. Of course, there are also those that would like much more risk sensitivity with no additional burden, but that just does not seem possible in this case. As we develop the NPR for Basel I amendments, the agencies will have to analyze very carefully where we want to end up on the risk-sensitivity-versus-burden tradeoff. And of course we expect to solicit comments on that tradeoff.

Additionally, we recognize the need for full transparency about the Basel II proposal and proposed Basel I amendments. For that reason, we intend to have overlapping comment periods for the NPRs of both proposed Basel II and the proposed Basel I amendments, so that banks and others can review and comment on both NPRs at approximately the same time. In particular, bankers from potential opt-in institutions and those not planning to move to Basel II can evaluate the potential impact of Basel II in light of the proposed Basel I amendments. In fact, we want all interested parties to compare, contrast, and comment on the two proposals in overlapping timeframes. At this point, we are still reviewing the comments received on the ANPR for amendments to Basel I. The comment period ended in mid-January. The agencies are developing their proposals for Basel I amendments, based on comments received, and hope to have a Basel I NPR by summer.

Finally, I would like to underscore that the U.S. agencies welcome any and all comments on these documents. Accordingly, our proposals could change on the basis of comments we receive or new information we gather. We know that this can be frustrating to some. Still given the breadth and depth of these proposals, it is critical that we consider all viewpoints. To date, comments from bankers--at all sizes of institutions--have been quite helpful. We request that you continue providing feedback on all the regulatory capital proposals we are contemplating.

Conclusion

I hope you found my remarks about recent regulatory initiatives informative. Naturally, bankers may be somewhat concerned about the impact these initiatives--even proposed guidance--could have on their business. We hear your concerns about "piling on," but I think it is helpful to remember that our job as regulators is to ensure that the United States has a safe and sound banking system. In other words, we are in the business of monitoring "downside risk" to the financial system, so we must act appropriately when we see possibly excessive risk-taking or inappropriate risk management, controls, or capital. While most U.S. banks today operate in a safe and sound manner, we must always be vigilant of future problems.

I hope it is clear that we are sensitive to the regulatory burden that bankers face; that is one reason why we often issue guidance first as proposals, requesting comments. Indeed, the Federal Reserve is quite responsive to regulatory burden, as evidenced by the recent Senate testimony of Governor Kohn on the subject. Overall, we believe that banks can remain profitable while still adhering to the standards set by banking regulators. And when we propose changes in our policies or guidance, we continue to listen carefully to industry comments and concerns.

Thank you.