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TESTIMONY OF

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COMPTROLLER OF THE CURRENCY

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

of the

COMMITTEE ON FINANCIAL SERVICES

of the

U.S. HOUSE OF REPRESENTATIVES

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

INTRODUCTION

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

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

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

RISK-BASED CAPITAL

Let me begin with the risk-based capital proposals. The agencies have developed two distinct proposals to better tailor a bank's capital rules to the complexity of its risks. For our largest banks, the fundamental thrust of our efforts is the U.S. implementation of the Basel II Framework – a more risk-sensitive regulatory capital system better suited to the complex operations and activities of these institutions. For banks not adopting Basel II, the primary goal of our so-called Basel IA initiative is to increase the risk sensitivity of our risk-based capital rules without unduly increasing regulatory burden.

Basel II

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

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

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

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

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

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

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

As has been widely reported, we have received several comments on a draft version of this NPR that was released earlier this year. Certain of those commenters requested that we amend the NPR to permit Basel II banks the option of using simpler approaches in the calculation of capital requirements for credit risk and operational risk. To ensure that all interested parties have the opportunity to comment on this fundamentally important issue, the agencies added a question to the Basel II NPR's preamble addressing this issue. As I mentioned earlier, one of the primary goals of the agencies in developing these proposals is – as much as possible – to tailor a bank's capital rules to the complexity of its risks. Thus, the advanced approaches of the Basel II NPR are targeted to large, complex banks. By the same token, the simpler Basel II approaches, as well as the forthcoming Basel IA proposal, have been developed with an eye towards less complex banks with more traditional risk profiles and activities. In this regard, we are very interested in comments on the appropriateness of permitting simpler alternatives to the advanced approaches for our largest, most complex banks, especially as it relates to safety and soundness and competitive equity concerns. I believe this is a legitimate question, given that the largest banks in other Basel II countries have the option of simpler alternatives to the advanced approaches. On the other hand, as the agencies note in the preamble to the NPR, virtually all non-US banks comparable in size and complexity to our core banks appear to be adopting the advanced approaches, though not with the changes that we propose in the NPR. I hope commenters will take all these factors into account when responding to the question.

The agencies have also received comments from U.S. banks expressing concerns about what they believe is the excessive conservatism of the NPR. Many of the specific provisions of the NPR cited by the banks relate to safeguards put in place by the agencies after an assessment of the results of our last quantitative impact study, discussed below, including the enhancement of the NPR's transition period to strictly limit potential reductions in capital requirements through capital floors and other devices.

In previous Congressional testimony, in Basel Committee deliberations, and in discussions with the industry and other supervisors, the OCC has repeatedly emphasized that reforms to our regulatory and supervisory structure must be adopted in a prudent, reflective manner, consistent with safety and soundness and the continued competitive strength of the U.S. banking system. In furtherance of those standards, the U.S. agencies conducted Quantitative Impact Study 4 (QIS-4) in late 2004 and early 2005.

It is well known that QIS-4 helped us identify significant issues about Basel II implementation that have not been fully resolved. The QIS-4 submissions evidenced both a material reduction in the aggregate minimum required capital for the QIS-4 participant population and a significant dispersion of results across institutions and portfolio types. One measure produced by QIS-4 is the estimated change in "effective minimum required capital," which represents the change in capital components, excluding reserves, required to meet the eight percent minimum total risk-based ratio. This measure is independent of the level of capital actually held by institutions and of their currently measured capital ratios. After application of a scaling factor as proposed in the NPR, the decrease in effective minimum required capital compared to existing standards was 11.7 percent, with a median decrease of 22.6 percent, aggregating over the QIS-4 participants. Additional QIS-4 analyses also confirmed that the dispersion in results – with respect to individual parameter estimates, portfolios, and institutions – was much wider than we anticipated. In particular, the agencies' additional analysis revealed a wide dispersion of results between institutions with respect to individual credit exposures and selected portfolios, even when controlling for differences in risk.

In short, the QIS-4 results and the inevitable questions they raise have been the source of serious concern for the banking agencies. There is consensus among the agencies that, if these were indeed the results that would be produced by a final Basel II rule, that would be unacceptable. Having said that, there were very significant limitations to QIS-4, and as a result, it would be a mistake to assume that the magnitude of the reduction and dispersion in capital requirements that were estimated would hold true with a fully implemented Basel II rule. In particular, because the regulators had not yet specified all the requirements for a complete Basel II regime, QIS-4 could not be designed to take into account such requirements. Even more important, the integrity of the final capital requirements produced by a "live" Basel II system will be affected fundamentally by the scrutiny that examiners will apply to the inputs that banks will provide to produce the final capital requirements. With a final rule, final supervisory guidance, and rigorous examiner scrutiny, we believe the magnitude of capital reductions and dispersion revealed by QIS 4 is likely to be mitigated.

Nevertheless, that outcome is not assured, and as a result, the process for implementing Basel II as established in the NPR is designed to provide the OCC and other agencies a complete understanding of the Framework's implications for the banking system without risking unacceptable capital reductions. Specifically, the Basel II NPR includes several key elements that allow for the progress we believe is necessary, over time, for risk management and supervisory purposes, while strictly limiting reductions in risk-based capital requirements that might otherwise result from systems that have not been proven.

The first element is a one-year delay in initial implementation, relative to the timeline specified by the Basel II Framework. As a result, the "parallel run," which is the pre-qualification period during which a bank operates IRB and AMA systems but does not derive its regulatory capital requirements from them, will be in 2008. The parallel run period, which will last at least four quarters but could be longer for individual institutions, will provide the basis for the OCC's initial qualification determination for national banks to use Basel II for regulatory risk-based capital purposes. Following initial qualification, a minimum three-year transition period would apply during which reductions in each bank's risk-based capital would be limited. These limits would be implemented through floors on risk-based capital that will be simpler in design and more conservative in effect than those set forth in Basel II. For banks that plan to implement the Basel II Framework at the earliest allowable date in the United States, we are proposing the following timetable and transitional arrangements:

Year	Transitional Arrangements
2008	Parallel Run
2009	95% floor
2010	90% floor
2011	85% floor

The OCC will assess national banks' readiness to operate under Basel II-based capital rules consistent with the schedule above and will make decisions on a bank-by-bank basis about termination of the floors after 2011.

We will also retain the Prompt Corrective Action (PCA) and leverage capital requirements in the proposed domestic implementation of Basel II. For more than a decade those provisions have complemented our basic risk-based capital rules, and U.S institutions have thrived while building and maintaining strong capital levels – both risk-based and leverage. This capital cushion has proved effective, not only in absorbing losses, but also in allowing banks to take prudent risks to innovate and grow.

While we intend to be true to the timelines above, we also expect to make further revisions to U.S. Basel II-based rules if necessary during the transition period (*i.e.*, before the system-wide floors terminate in 2011) on the basis of observing and scrutinizing actual systems in operation during that period. That will allow us to evaluate the effectiveness of the Basel II-based rules on the basis of real implementation and to make appropriate changes or corrections while the prudential transition safeguards are still in effect. In other words, we will have strict safeguards in place to prevent unacceptable capital declines during the transition period, and if we believe that the rule would produce such declines in the absence of these safeguards, then we will have to fix the rule. Of course, any future revisions will also be subject to the full notice and comment process, and we expect to look to that process where necessary to help resolve difficult issues.

Having said all of this – especially the need for caution during the transition period – there may well be parts of the proposal that are overly conservative. The notice and comment process will undoubtedly result in a complete discussion by commenters of provisions that raise such concerns. I will carefully consider such comments, and to the extent they are valid, I believe we should make changes to the rule before it becomes final.

The OCC has been a frequent critic of many elements of the Basel II Framework, and we have worked hard to make important changes to the proposal that we thought made sense. But it is also true that, at critical points in the process, the OCC has supported moving forward towards implementation. Our reason for doing so is simple – an appropriate Basel II regime assists both banks and supervisors in addressing the increasingly complex risks faced by our largest institutions. While we may not have all the details of the proposals right yet, and we will surely make changes as a result of the public comment process, I fully support the objectives of the Basel II NPR. I want to see these proposals work because I am convinced that, if they do, they will strengthen the safety and soundness of the banking system.

Basel IA

The complex Basel II NPR is neither necessary nor appropriate for the vast majority of U.S. banks. Many of these institutions need meaningful but simpler improvements in their risk-based capital rules to more closely align capital with risk. The OCC's primary objective in developing the Basel IA proposals is to create a domestic risk-based capital rule with greater risk sensitivity, but without unduly increasing complexity or burden. That is no small challenge, and we recognize that there will be limits in the level of risk sensitivity that we can achieve in a relatively noncomplex rule designed for broad applicability to a vast array of credit exposures.

Nonetheless, we believe there are areas in which our current rules can be significantly improved without requiring massive investments in new systems and controls. In that respect, it is important to note that, unlike Basel II, the Basel IA proposals are not intended, in and of themselves, to dramatically improve risk management. Rather, they represent an effort to design a simple but better measure of minimum regulatory capital requirements. Likewise, the results of Basel IA are not intended to replicate Basel II results – but by moving risk measurements in the right direction, we do expect to narrow some of the potential gaps between Basel IA and Basel II results.

The agencies remain committed to issuing the Basel IA NPR in the near future. We believe that overlapping comment periods for these two rulemakings is a critical element of our on-going effort to assess the potential competitive effects of both sets of proposals on the U.S. banking industry.

PROPOSED COMMERCIAL REAL ESTATE GUIDANCE

The agencies proposed guidance on January 13, 2006 to address sound risk management practices for banks with concentrations in commercial real estate (CRE) loans. The guidance focuses on concentrations in CRE loans that are particularly vulnerable to cyclical commercial real estate markets, those where the source of repayment primarily depends upon rental income from the property, or the sale, refinancing, or permanent financing of the property.

Last year, banks held about $1.3 trillion in CRE loans nationwide – a 16% increase in just one year. CRE lending is clearly an important and profitable line of business for many banks, so it is not entirely surprising that our proposed guidance has generated an outpouring of comment letters. We at the OCC have received more than 1,600. The concerns expressed in these comment letters have been amplified in many of my face-to-face discussions with bankers, especially mid-size and community bankers.

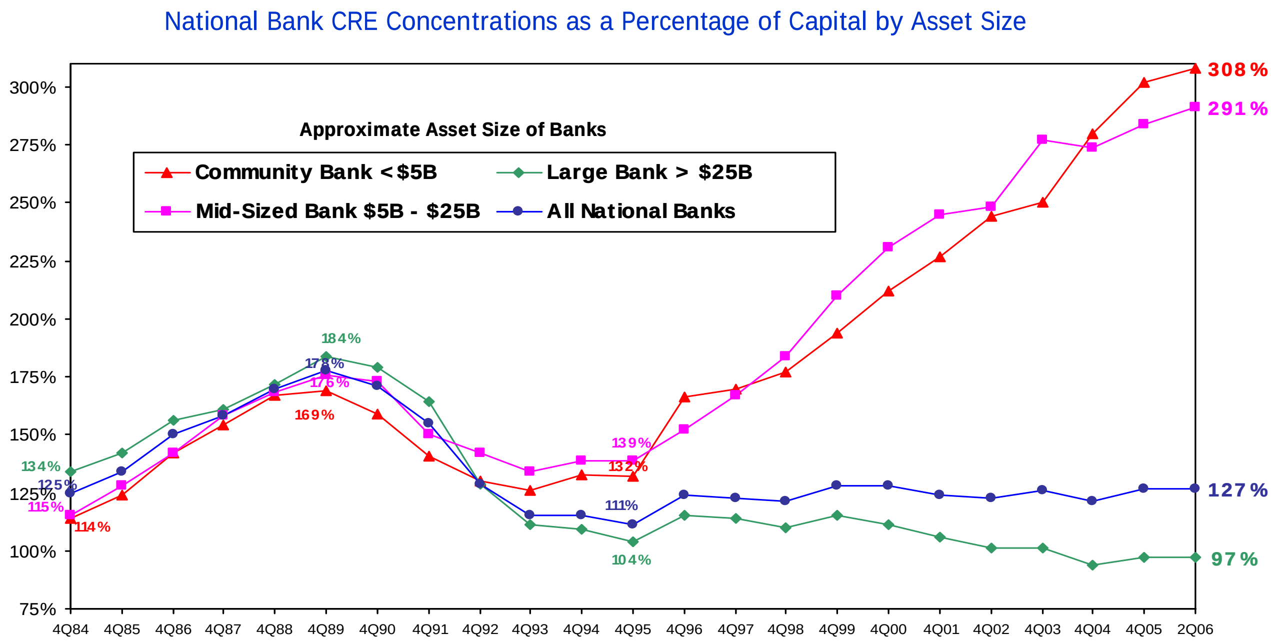
These bankers point out that commercial real estate has been a very strong business: the underlying collateral is real; demand has remained strong; and smaller banks can compete. In this context, bankers worry that the proposed guidance will cap or restrict their participation in one of their best performing sectors.

That is not what the guidance is intended to do. The guidance is intended to outline prudent risk management practices. Concentrations in commercial real estate lending – or in any other type of loan for that matter – do raise safety and soundness concerns. It is our job as regulators to focus institutions on ways to address those concerns. But our message is not, "Cut back on commercial real estate loans." Instead it is this: "You can have concentrations in commercial real estate loans, but only if you have appropriate risk management and capital to address the increased risk." And in terms of "the appropriate risk management and capital, " we are not referring to expertise or capital levels that are out of reach or impractical for community and mid-size bankers.

In response to some of the worries and misconceptions that have been expressed about the proposed guidance, let me provide more detail about three points: why regulators are concerned; what the guidance says to address those concerns; and, in practice, what the guidance really means and does not mean.

In terms of our concerns, today 35 percent of national banks hold commercial real estate loans in amounts exceeding 300 percent of capital. Nearly all of these institutions are mid-size or community banks which, as illustrated in the chart below, in the not-too-distant past rarely exhibited this degree of concentration in this type of lending.

CRE Loan Concentrations



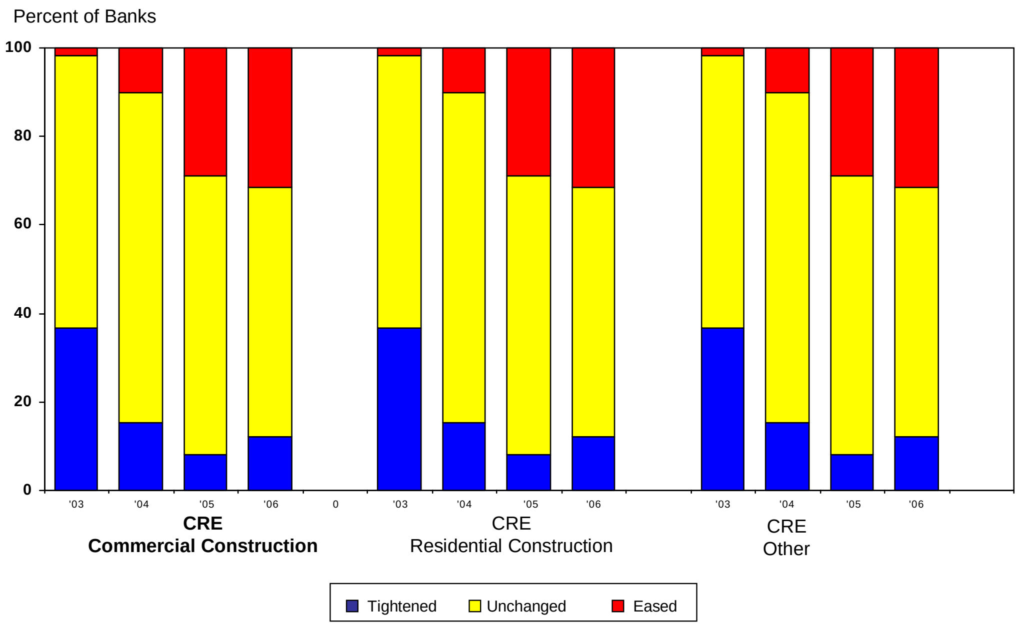
In some ways, the 45 degree slope of the red line speaks for itself, but let me provide some additional context about what it means. Not very long ago, if a national bank held loans of any type exceeding 300 percent of capital, that would have triggered a serious discussion with the board of directors about plans for diversification and possibly more capital.

Then as now, we emphasize the fundamental principle that loan concentrations require enhanced risk management from bankers, and enhanced scrutiny from supervisors. That is especially true if the concentration is in an asset category as volatile as commercial real estate – a business well known for its sharp and unpredictable turns. We saw this volatility most recently – and, for many bankers, disastrously – in the late

1980s and early 1990s. The degree to which banks participated in the run-up of the commercial real estate market in the early '80s proved to be one of the best predictors of subsequent bank failure. On average, banks that failed had nearly three times as many commercial real estate loans as a percentage of their total assets as banks that did <u>not</u> fail. Perhaps even more striking, all but the largest banks in that period had much <u>lower</u> concentrations in commercial real estate than they do today. For example, in 1989 nationally chartered community banks as a group had commercial real estate loan concentrations of approximately 169 percent of capital – compared to 308 percent today.

Thankfully, credit underwriting standards for commercial real estate lending today are much more rigorous than they were in the 1980s. Nevertheless, we have seen slippage at some banks in the last two years that has compounded our concerns with increased concentrations. Beginning in 2003, the OCC conducted a series of "horizontal" examinations – ones that focus on a single line of business across multiple institutions – in order to supplement and deepen our regular examination analysis. We found erosion in key areas: lengthening maturities, increasing policy exceptions, narrowing spreads, and lack of independence and quality control in the appraisal process. As the attached chart shows, our annual credit underwriting survey of the 73 largest national banks confirmed that standards for underwriting all types of CRE loans eased again in 2006. While underwriting standards generally remain acceptable, the easing trend is something we will continue to watch closely.

Commercial Real Estate Underwriting Trends



Our horizontal reviews also revealed that risk management practices had begun to lag the risks raised by increasing commercial real estate concentrations. Some banks demonstrated weaknesses in the fundamental risk management areas of board and management oversight, sound underwriting and internal controls, risk assessment, and monitoring – especially the type of monitoring that should be taking place through effective management information systems. In other cases, banks were not taking advantage of newer technological tools that help manage concentration risk, including basic risk management models and stress testing methods. These tools do exist; they are more powerful than ever before; and they are available to community and mid-size banks.

In short, while we believe that commercial real estate concentrations can be safely managed, *they must be effectively managed in order to be safe*. And because we were seeing weaknesses in that management, we issued the proposed guidance.

The basic premise of the new guidance is unchanged from the 1993 interagency guidance on commercial real estate lending, which the OCC updated and incorporated into a separate examination handbook in 1998. It is this: where commercial real estate loan concentrations exist, banks should have risk management systems and capital appropriate to the risk of those concentrations. Indeed, at its core, the proposed new guidance is simply a restatement and amplification of the supervisory guidance that the agencies developed in the wake of widespread bank failures precipitated by commercial real estate lending fewer than 20 years ago.

What the proposed guidance does for the first time is provide a simple definition of what we mean by commercial real estate concentrations. This definition is intended to answer the questions we have received over the years from many bankers frustrated with the ambiguity and lack of clarity of our previous guidance. Specifically, the proposed guidance provides more straightforward concentration thresholds that, once crossed, trigger expectations for enhanced risk management and capital levels. The first threshold is defined as those commercial real estate loans made for construction, land development, or other land that in the aggregate exceed 100 percent of capital. The second threshold applies when all commercial real estate loans made by a bank exceed 300 percent of capital. Importantly, the definition excludes farm loans, residential loans, and owner-occupied loans, where repayment depends upon the operating performance of a business, but does include unsecured loans to developers and REITs.

The agencies chose 100 and 300 percent as benchmarks after three years of intensive discussions involving experts from the private ratings agencies, the banking industry, and fellow regulators. These experts reported on their decades of experience in assessing commercial real estate lending and correlating it with risk. The degree of consensus on what constituted fair and reasonable benchmarks for concentration was striking, and that consensus translated into the benchmarks that the agencies unanimously proposed.

Having defined commercial real estate concentrations, the proposed guidance then sets forth the agencies' risk management and capital expectations for banks that have concentrations. Regarding the former, the guidance elaborates on the principles and components of an effective risk management program. For example, instead of simply invoking the importance of effective board and management oversight, the guidance discusses what that might include, such as timely reports on changes in market conditions and the bank's activity and risk profile. It further discusses the elements of a solid information system that allows management to better understand risk by tracking property type, geographic area, tenant concentrations, tenant industries, developer concentrations, risk ratings, and the like. And it describes in detail enhanced underwriting practices, so banks can take appropriate corrective action, if needed, before their next examination.

In terms of capital, the proposed guidance is more general: it says simply that banks with commercial real estate concentrations should hold capital higher than regulatory minimums and commensurate with the level of risk in their commercial real estate portfolios. While it is hard to argue with that basic proposition, commenters have indicated considerable uncertainty about what it will mean in practice, just as there have been repeated questions about what we really mean by our discussion of effective risk management practices. I think it is important to address what the proposed guidance would mean in practice, and what it would not mean, including several of the misconceptions that surround the guidance.

Probably the most common concern expressed is that the 100/300 percent thresholds will quickly turn into hard caps – that is, examiners will apply the guidance in a way that will effectively leave banks no choice but to reduce their commercial real estate lending in order to reduce their concentrations to levels below the thresholds. Again, let me say categorically that this is not our intent. Far from being caps, these numbers are simply screens to determine where enhanced risk management and adequate capital is needed. Of course, those institutions that are unable or unwilling to make such enhancements should reduce or avoid concentrations, but that is a very different point from saying categorically that the thresholds are caps or limits. At the OCC, we are emphasizing this very point – that the thresholds are triggers for better prudential practices, not caps – in discussions with our examiners in every region of the country, and we plan to further clarify this point in any final guidance.

The other concern most often expressed involves the capital part of the guidance. Notwithstanding the actual language in the proposal, which is quite general, some bankers are worried that supervisors plan to seize the guidance as an opportunity to increase capital requirements for any institution exceeding the concentration thresholds. Again, that is certainly not the intent of the OCC. It is true that the proposed guidance calls for capital exceeding regulatory minimums for institutions that hold such concentrations. But the simple fact is that the overwhelming majority of such institutions already hold capital cushions that exceed regulatory minimums by more than two hundred basis points, and, as a result, these institutions generally would not be affected by the capital adequacy part of the guidance.

More important, our focus in applying this guidance will be first and foremost on risk management practices. To the extent that an institution with a concentration exceeding one of the thresholds has enhanced risk management practices in place, or is moving in that direction, our concern with increased capital is greatly reduced. By the same token, an institution with a concentration but no prospect of enhancing risk management practices within a reasonable period of time would indeed be a candidate for capital above the regulatory minimums.

Finally, there is a certain amount of concern that the guidance will be implemented in an arbitrary and inconsistent manner, disadvantaging some lenders and benefiting others. In truth, one reason for issuing the guidance was that, over the decade since similar guidance was last issued, bankers had complained about growing variances in interpretation and application across charters and geographic regions. This was not only a source of frustration and confusion for the industry; it also tended to undermine the credibility of our regulations and supervision. Our new proposed guidance is intended in part to achieve greater consistency and a more level playing field among all financial institutions.

In closing, any discussion of the supervisory implications of commercial real estate lending inevitably evokes the banking crisis of more than a decade ago – a crisis in which commercial real estate lending clearly played a critical role and left an indelible mark. It is hard to overstate the impact of that crisis on our economy, which ultimately left more than 1,600 banks closed or in need of government assistance and nearly bankrupted the deposit insurance fund. That experience profoundly affected the views of bank supervisors.

On the other side of the coin, many of us also have vivid memories of the so-called "credit crunch" of the early 1990s, when credit for commercial real estate became very difficult to find. Some argued that regulators had overreacted to the banking crisis by mandating overly restrictive underwriting policies, while others believed that bankers themselves were overreacting to the problems caused by past credit practices. Either way, it was a painful period from which it took a good bit of time to recover.

Needless to say, when it comes to commercial real estate, regulators and bankers should be doing all that we can to avoid <u>both</u> increased bank failures <u>and</u> a credit crunch. The best way to do that is to address smaller concerns effectively before they grow into much bigger problems that precipitate more extreme actions and reactions. That is precisely what the proposed guidance is intended to do. As a result, we will continue to work with our colleagues at the other agencies to address the concerns expressed in the comment letters and to clarify that our focus is on the importance of sound risk management practices.

Thank you very much.