Thrift Institutions Advisory Council
Comments on Basel II Capital Standards
March 5,2004

Regulations H and Y; Docket No. R-1154

At the meeting of the Thrift Institutions Advisory Council with the Board of Governors on March 5,2004, Roy Whitehead, President and Chief Executive Officer, Washington Federal Savings, Seattle, Washington, and Curt Hage, Chairman and Chief Executive Officer, Home Federal Bank, Sioux Falls, South Dakota, presented the following views on the advance notice of proposed rulemaking on the proposed framework for implementing the New Basel Capital Accord in the United States.

The members of the Council are very concerned about the competitive impact that Basel II will have on non-adopters. We are concerned because of the difference in capital requirements for the same assets and because of the possible impact on consolidation in the industry. Adopters of Basel II will see capital requirements for mortgage loans significantly reduced. Those institutions will be able to deploy their lower cost of capital to advantageously price mortgage loans and to acquire smaller institutions. Adopting banks will have excess capital to deploy and may pursue aggressive leverage and growth strategies, including increased focus on mortgage lending. Adopters could cherry pick the good credits and prime businesses of community banks. This will require changed strategies and business models by non-adopters.

If capital standards were lowered for Basel I1 banks, operations at thrifts, at least initially, probably would not change. The focus of thrifts has not been to reduce capital to the lowest possible levels. Thrifts have taken a responsible position in ensuring that there is an adequate cushion of capital for unforeseen events. However, thrift operations may have to change as a defensive move in order to compete with larger institutions that do want to reduce capital to the lowest acceptable levels and then price mortgages aggressively. Because thrifts are heavily invested in mortgages, the minimum leverage requirements will place constraints on the ability to lower overall capital requirements even if capital for mortgages is lowered. This is not true of commercial banks that could use excess capital to build up their mortgage lending operations, but remain above minimum leverage ratios because of other, higher risk businesses. In many situations, small- to medium-sized banks will be forced to make less desirable loans to maintain business.

There also will be an impact on those institutions that securitize assets. Institutions complying with Basel II will not have to hold dollar for dollar capital for all residuals. They will be able to stratify the risk by tranche to a greater degree than non-Basel 11 institutions. This would be another example of the negative competitive impact that the requirements would have on the banks unable to implement the changes.

The Council believes that current capital requirements for mortgages are relatively high compared to the requirements for other types of loans and in light of the low risk of loss. Therefore, changes should be made to the capital requirements for Basel I banks. Revisions could include more baskets and a breakdown of mortgage loans into multiple baskets when taking into consideration factors such as loan-to-value ratios and credit scores. To the extent that there is complete and reliable data and evidence of the risk, adjustments for concentration risk could be made as well. Credit mitigation measures, such as mortgage insurance and guarantees, could be incorporated into a revised framework. Revised treatment of other types of loans, such as small business and consumer loans, could also be made so that the capital requirements are more closely aligned with the risk of these assets. Higher capital charges should not be assessed merely to retain near-capital neutrality for Basel I banks, but should be assessed against assets if appropriate to address increased risk.

In all cases, the Council agrees that a capital cushion is appropriate since it is impossible to take into account all possible future risk events. The current minimum should continue and be the same for everyone. Risk modeling techniques have improved over the years, but they are not perfect. There also may be problems with obtaining the necessary data and modeling cannot take into account all possible internal and external events. Therefore, maintaining an overall minimum capital requirement is prudent. It is likely that the investment community will require this as well until everyone is more comfortable with the models used by institutions in determining adequate capital and there is more information about the models available to the marketplace.

In response to one of the questions submitted to the council, Mr. Whitehead agreed strongly that, when Basel II is adopted, regulatory agencies should reduce the current minimum regulatory capital charge at non-adopters on conforming residential mortgages with strong loan-to-value ratios.