Letter from the Director

Ask any banker his view on the Basel II rulemaking and you are likely to hear conflicting responses. Given the major changes that will occur in how we measure risk-based capital adequacy at the largest, most sophisticated insured financial institutions, we should anticipate that other banks will scrutinize all aspects of the regulators' implementation plans. Many comments, including some criticism, have already been delivered by banks that will not be required to adopt Basel II. Why would these bankers take issue with the Basel II text? The most often cited reason is the potential for competitive inequity.

The results of the most recent capital impact study (the fourth Quantitative Impact Study – QIS-4) show Basel II would most likely lead to an unacceptably large decline in capital for the largest banks unless modifications are made (see the *Capital and Accounting News* feature on page 27 for greater detail on the QIS-4 results). Competing head to head with large banks, holding in some cases a fraction of the capital non-Basel II banks hold on the same loan portfolio, would be a daunting challenge for the nation's community banks.

At this point, the bank regulatory agencies have two alternatives. The first is to modify the Basel II framework to prevent substantial declines in capital — something the agencies are committed to doing should the QIS-4 results become a reality when Basel II is implemented. The second alternative is to modify the existing capital framework for non-Basel II banks to reduce, among other things, competitive inequities. This Letter focuses on the modification of the existing capital framework for non-Basel II banks.

To better understand the competitive issues Basel II may pose to non-Basel II banks, the agencies began a formal rulemaking dialogue with the banking industry. We did this with the publication of an Advance Notice of Proposed Rulemaking (ANPR) outlining potential changes to the existing risk-based capital regulations. The ANPR was unanimously approved by the FDIC Board of Directors on October 6, 2005, and published in the ***Federal Register*** on October 20, 2005.[1] The agencies are accepting public comment through January 18, 2006, and welcome a discussion with the industry, policymakers and the public.

The FDIC believes changes to the existing risk-based capital framework are necessary in order to address concerns about competitive equity, as well as many of the concerns about the risk-based capital framework generally. The proposals in the ANPR, commonly referred to as Basel 1A, are designed to be the first step toward modernizing the risk-based capital framework to ensure it remains a reliable measure of the risk, as well as minimize potentially material differences in capital requirements likely to emerge once Basel II is implemented by the largest banks.

One key proposal set forth in the ANPR addresses modifications to the existing capital requirements on residential mortgages. It is generally accepted by the bank regulatory community that Basel II banks will recognize substantial capital reductions on their residential mortgage portfolio. For non-Basel II banks, the ANPR suggests basing the risk weights for mortgages on loan-to-value ratios, a simple and straightforward measure of risk. For prudently underwritten mortgages with a loan-to-value ratio of 80 percent, the ANPR considers reducing

[1] This proposal is available at www.fdic.gov/news/news/press/2005/pr10505.html. Also see *Federal Register:* October 20, 2005 (Volume 70, Number 202), Page 61068-61078.

the risk weight from 50 percent to 35 percent. Mortgages with even lower loan-to-value ratios could have risk weights as low as 20 percent. The residential mortgage proposal shows willingness by the regulators to address concerns raised by community banks. In fact, this proposal is based largely on suggestions made by several of our FDIC-supervised banks.

The ANPR includes other specific proposals, such as increasing the number of risk-weight categories from five to nine, expanding the use of external credit rates, and widening the range of collateral and guarantors that may qualify an exposure for a lower risk weight. Such proposals are intended to encourage community banks to consider using risk mitigating techniques that lower their overall credit risk profile. In other areas, the ANPR is more open-ended, discussing concepts for promoting greater risk sensitivity in other business lines where risk measurement factors are not well defined or universally applied, such as with unrated commercial loans and certain retail loans.

In addition, the ANPR proposes modifications to the existing risk-based capital rules where quantitative factors used to measure the risk associated with a given product or exposure can be readily articulated. Examples of these changes include modifying the credit conversion factors for various commitments, including those with an original maturity of less than one year; increasing the risk weight of certain loans 90 days or more past due or in non-accrual status; and increasing the risk sensitivity of commercial real estate, retail, multifamily, small business, and commercial exposures.

While developing a more risk sensitive framework is important from a competitive equity perspective, the agencies want to ensure the burden generated by our proposals is commensurate with the benefit. In this respect, we believe most, if not all, of the proposals discussed in the ANPR could be applied using readily available information. However, we have asked for comment on whether the trade-off of a more risk-sensitive capital framework is justified by the amount of any additional burden that may be generated by its implementation. To prevent undue burden, we are looking for ways to make the application of any new capital rules more flexible. In addition, we are asking for comments on whether some community banks should be allowed to maintain "status quo" and opt out of any new framework altogether. Community banks operating with capital ratios well in excess of their minimums may suggest that we pursue this "status quo" option.

The FDIC is encouraging careful consideration of the implications of the proposals included in the ANPR. In addition to comments on the specific proposals set forth in the ANPR, we would welcome any alternatives or suggestions that will promote the development of more comprehensive proposals. Examiners should keep informed as the Basel 1A and Basel II approaches develop. ***Supervisory Insights*** is one source of information, and this issue's *Capital and Accounting News* column discusses the results of the most recent Basel II quantitative impact study (QIS-4).

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