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AMERICAN BANKERS ASSOCIATION ®

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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
4022 Basel
Switzerland

Communications Division
Office of the Comptroller of the Currency
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Washington, D.C. 20219
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Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
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Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
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Ladies and Gentlemen:

The Basel Committee on Banking Supervision ("BCBS") has requested comments on a second round of consultative papers outlining a new Basel Capital Accord Framework ("Accord"). United States federal banking regulatory agencies (the "Agencies", which include the Federal Deposit Insurance Corporation, the Federal Reserve Board and the Office of the Comptroller of the Currency) have also requested comments from U.S. bankers on the proposed Accord, which, if adopted, could apply to a number of domestic commercial banks, bank holding companies and financial holding companies. The American Bankers Association ("ABA") brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and bank and financial holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest bank trade association in the country.

Before presenting our comments, we believe it important to establish the context of the U.S banking industry and the member banks and holding companies that ABA represents. As of December 31,

2000, there were over 8,000 commercial banks and over 1700 savings associations in the United States, ranging in size from some with less than $10 million in assets up to approximately 50 institutions with over $10 billion in assets. Approximately two-thirds of these institutions are part of a bank holding company, a thrift holding company or one of the newly authorized financial holding companies. The vast majority of these institutions are community and/or noncomplex banks engaged in traditional banking activities that ABA believes should not be subject to the new Accord. Rather, ABA believes that the Accord should apply only to the largest banks.

Given this perspective, ABA consulted with approximately 30 large U.S. banks, ranging in size from just under $10 billion to more than $800 billion in assets. Even within this small group of banks, there was considerable difference in their scope and range of activities. Some were largely retail institutions with relatively simple operational profiles; some were specialized banks, such as primarily credit card banks or home mortgage lending banks; and some were internationally active banks within financial holding companies engaged in a diversity of securities, insurance and other financially-related activities. As a result, their responses to the proposed Accord often differed, sometimes widely. That diversity is reflected in these comments.

Overall Comments on the Accord

First, ABA now believes that the ambitious timetable set by the BCBS for adoption of the final Accord can not be met without either leaving significant gaps in or introducing significant defects into the final Accord. ABA further recommends that the BCBS should not only fill in the missing details of the proposed Accord but also should then entertain another round of consultative papers based on revisions made as a result of this round of consultation.

Second, ABA believes that the U.S. Agencies must limit the application to the Accord to only the very largest domestic institutions. The proposed Accord is simply inappropriate for the vast majority of smaller, noncomplex banking institutions in the U.S. Further, the proposed application of the Accord to holding groups that “predominantly engage in banking activities” will create competitive disadvantages for banking organizations compared to other financial services organizations. Differences in national treatment of banking organizations allowed under the Accord will also create competitive disadvantages between banking organizations across national borders. ABA believes that the Accord must be revised to eliminate these competitive disadvantages built into the Accord.

Third, ABA has supported and continues to support the BCBS’s efforts to align more closely capital standards with actual risk. The current proposal moves considerably further along that vector by more fully developing the opportunity for banks to use internal risk models to assess adequacy of capital. Among other positive aspects of the proposal that we support are the use of internal risk-based approach, especially as presented in the advanced approach; the recognition of credit risk mitigation in setting capital support, and the attempt to build incentives into the Accord that encourage and reward development and adoption of better risk modeling techniques.

At the same time, however, ABA believes that there are significant problems with Pillar 1 of the current proposal that prevent the Accord from realizing its goal of aligning regulatory capital with true economic risk. Instead, the proposed Accord would require higher and unnecessary levels of capital. Several factors working together lead to this result, including:

- a standard approach that requires too much capital and the significant barriers to moving up to the internal ratings approaches;
- too conservative calibration of the internal ratings approaches, including the "all or nothing" requirement for qualifying for the advanced approach and the imposition of the floor of 90 percent of the foundation approach to the banks using the advanced approach;
- a requirement that capital be held for both expected and unexpected losses rather than just unexpected and unreserved losses;
- too conservative treatment of collateral and other credit risk mitigation techniques;
- too conservative treatment of asset securitizations;
- the inclusion of an operational risk capital charge that is arbitrary, undeveloped and not capable of being implemented

Fourth, ABA believes that the proposed disclosures outlined in Pillar 3 as part of a market discipline factor will be expensive to achieve and provide little value for that expense for U.S. banks.

Timing of the Accord

The BCBS intends to adopt a final Accord by the end of 2001, with full implementation to be required sometime in 2004. ABA is concerned that this may not be achievable. Significant portions of the Accord need yet to be completed, as ABA noted in the May 16 joint trade association letter to the BCBS, requesting that the BCBS issue interim papers by no later than August 2001 on several areas that remain incomplete in the Consultative Papers, including treatment of retail exposures, project finance, equity exposures, counter party risk in the trading book, and operational risk. While in that letter, ABA did not call for an extension of the proposed timetable for adoption of the Accord, ABA now believes that the wide range of responses to the proposed Accord require that the BCBS fill in these details and adjust the current proposal in light of comments filed since May 31 and engage in another round of consultative papers before finalizing the Accord.

Scope of Application of New Basel Accord

The Accord Should Not Apply to Community and/or Noncomplex Institutions

After the adoption of the Accord in 1988 by the BCBS, all U.S. FDIC-insured banks were made subject to the Accord by the U.S. Agencies and all savings associations were made subject to very similar requirements by their U.S. regulator. At that time the ABA urged the Agencies not to apply

the Accord to smaller, community banks, but rather only to large, internationally-active banks that were actually the subject of the Accord, but the Agencies believed that consistency in capital adequacy rules across all sizes of commercial banks was important.

In contemplation of a Basel Accord, the Agencies in November 2000 issued a request for comments on the appropriateness of applying a simplified capital adequacy standard to noncomplex banks. As ABA wrote in its comment letter, ABA's members "strongly support the Agencies' concept of not applying the eventual revision of the Accord to non-complex banks, irrespective of the size of the institution. While the approaches contemplated in the proposed revisions to the 1988 Accord may be appropriate for large, complex, internationally active banks, most non-complex domestic banks will not have or need the infrastructure to implement the proposal's sophisticated internal ratings-based approach to regulatory capital." After reviewing the approximately 600 pages of the Consultative Papers on the new Accord, ABA is even more convinced that the application of the new Accord must be limited to large, complex, internationally active banks and not imposed upon community and/or noncomplex institutions.

<u>The Accord Should Not Apply to Holding Companies of Predominantly Banking Groups</u>
The proposed Accord proposes to apply to holding companies, on a fully consolidated basis, that are parents of groups that are predominantly banking groups. The Accord would also apply on a sub-consolidated basis to all internationally active banks at every tier below the top banking group level. The Accord states that this is the best way to preserve the integrity of capital and to eliminate double gearing in a banking group. However the proposed Accord would allow differences in national treatment of some financial subsidiaries. The Accord would not consolidate insurance subsidiaries, requiring instead the deduction of bank investments in such. Further, the Accord would deduct from banks' capital any significant investments in commercial entities that exceed certain thresholds. The Accord would apply in 2004.

At the same time, the U. S. has approached the issue of appropriate supervision of financial conglomerates from the opposite direction. The U. S. prohibited formation of financial conglomerates in the 1930s <u>and</u> later also imposed bank capital requirements on bank holding companies. ABA has always believed such capital requirements were unnecessary, given the supervision of the banking subsidiaries and the restrictions on formation of financial conglomerates. In 1999, the U.S. authorized a wider range of financial activities for holding companies -- new financial holding companies (FHCs) -- in the Gramm-Leach-Bliley Act (GLBA). This law authorized new financial conglomerates incorporating banking, insurance, and securities activities, including equity investments (merchant banking). In urging passage of GLBA, the ABA supported a model of supervision by "functional regulation." Under GLBA, the Federal Reserve, as umbrella supervisor, may assess capital adequacy of the FHC, but is prohibited from setting capital adequacy standards for non-bank financial subsidiaries. Those capital requirements do not apply to subsidiaries for which capital has been deducted from the bank. Further, GLBA does not permit the Federal Reserve to set capital requirements for commercial firms with large non-bank financial services operations, which are

barred from becoming FHCs. However, the Federal Reserve and federal banking regulators may establish restrictions on transactions between the bank and any affiliate or financial subsidiary.

A careful review of the developing system of supervision of financial conglomerates in the U. S. may provide guidance in developing an international approach, which presents several complex issues. First is the continuing issue of competitive equality. ABA strongly opposed the Federal Reserve's initial FHC capital proposal for merchant banking as excessive and as competitively disadvantaging banking organizations compared to securities or insurance organizations. While the final capital requirements ameliorated these concerns, they still remain. Similarly, while the Accord's imposition of capital at the holding company level could foster competitive equality among financial services firms, it could foster the same problems ABA is seeing domestically. If the supervisory approach to assessing capital of financial conglomerates is too conservative, it would result in excessive capital being required for financial conglomerates that are predominantly banking groups, creating competitive inequality with non-banking financial conglomerates. The proposed operational risk component is an example. In general, our members found the operational risk component would result in excessive levels of capital for the risks being captured. Most of our members recommended that operational risk be handled not from a capital adequacy approach (Pillar 1) but from a monitoring and supervisory approach (Pillar 2). This issue of competitive equality also is raised by the Accord's provision for different treatment of entities depending upon home country legal structures and interpretations of the "banking group" concept. Such national flexibility may limit the effectiveness of a holding company capital requirement to level the playing field across international borders.

Second, the supervision of internationally active financial conglomerates raises issues of parity of national supervision, differences in accounting standards and disclosure, and other components of a comprehensive, comparative supervisory framework. In fact, differences in (and limitations on) national supervisory authority and capacity may lead to an overemphasis on capital as a substitute for supervision, which ABA believes could well be inefficient and be competitively disadvantageous for financial conglomerates operating under a strong supervisory scheme or for those conglomerates characterized as predominantly banking vis-à-vis other financial conglomerates. The work of the national supervisors on increasing information sharing and the standardization and reliability of that information needs to continue in order to assure that capital does not become more important than the adequacy and consistency of the supervision of financial conglomerates.

Third, and consistent with ABA's concerns about the recently adopted U. S. FHC capital requirements, ABA continues to support a "functional regulation" approach to the supervision of financial conglomerates. Approaching capital as an outgrowth of functional regulation suggests that the Accord should be using something like the "building block prudential approach" described in Annex 1 of the Capital Adequacy Principles of the Joint Forum Report. Frontline emphasis should be on supervision and capital adequacy of the regulated subsidiaries. We think this is consistent with the approach taken in the U. S., where, in the words of the GLBA Conference Report, the Federal Reserve "may not promulgate rules, adopt restrictions, safeguards or any other requirement affecting a functionally regulated affiliate unless the action is necessary to address a material risk to the safety and

soundness of the depository institution or the domestic or international payments system <u>and it is not possible to guard against such material risk through requirements imposed directly upon the depository institution</u>." (Emphasis added.) The focus of supervision and of capital adequacy should be on the regulated subsidiaries, and not be pushed up into the parent holding company unless it is not possible to otherwise protect the subsidiaries. ABA believes that such an approach will lessen the potential for capital arbitrage across banking and non-banking financial conglomerates and across national borders.

The consolidated capital approach of the Accord raises difficult issues about the eventual treatment of equity investments and merchant banking. One of the pieces of the Accord not yet developed is when and how such equity investments will be required to be capitalized or to be deducted from capital. However, the outline presented appears to be inconsistent with the approach just adopted in the U.S., which, as we suggested above, should be studied further by the BCBS. Further, the Accord suggests that there may be considerable room for differences in treatment by national supervisor, which will create additional unwanted cross-border competitive disadvantages. Related to this is the Accord's intent to deconsolidate insurance from the banking group but to include securities within the banking group. Several of our banks observed that this approach could be very adverse to their final capital measure. They strongly believe that much further analysis needs to be done before these decisions are finalized.

<u>Pillar 1: Minimum Capital Requirements</u>

Every bank ABA consulted concluded that the proposal would not maintain capital at its current levels but would, in fact, result in an unjustified requirement of higher capital. This will not only disadvantage banking groups but will adversely affect borrowers by raising the cost of credit or limiting its availability. ABA believes that the BCBS must not adopt the Accord until this "overcapitalization" effect is removed. Some of the factors in the Accord that lead to these unwanted results are discussed below.

<u>1. The standardized approach is too conservative and too difficult to leave.</u>

Overall, our banks found the standardized approach to be less risk sensitive than anticipated and found the barriers to moving from the standardized approach to an internal ratings based ("IRB") approach to be significant. A number of our banks suggest that the standardized approach improves the current Accord by increasing the number of risk categories; nonetheless, they believe that the number of risk categories should be further increased to improve the granularity of the risk weightings. Specifically, banks recommended creation of risk categories for differences in credit quality between BBB+ and B- corporates.

The Accord also appears to require too high a level of capital for retail assets. While the proposed treatment of retail assets is still not detailed, the BCBS states that calibration of retail capital might be expected to be approximately half of that for wholesale assets. Our banks tell us that the actual ratio should be considerably lower. However, given that the treatment of retail assets remains undeveloped, ABA believes it very important that banks see the fully developed proposal and have adequate time to evaluate it and comment.

ABA also believes that the proposed Accord does not encourage moving from the standardized approach to one of the internal ratings approaches, and may actually disincent banks from moving up the risk model chain. Banks below $10 billion found the many proposed requirements for data collection and storage to qualify for the foundation and advanced IRB approaches difficult and expensive for them to implement. An example is the requirement that banks maintain a complete ratings history for each borrower. One possible approach to open up access to the internal ratings approaches might be to allow banks to use external mapping provided by vendors and participants in secondary markets for loans, although this would likely be slow to develop. Nonetheless, ABA is concerned that the Accord poses barriers to entry to the adoption of IRB modeling that will consign smaller banks to what is effectively a supervisory requirement that they be overcapitalized compared to the larger financial institutions against which they compete.

However, the most significant barrier to leaving the standardized approach is the Accord's requirement that the use of the IRB approaches be subject to an "all or nothing" treatment will discourage development and innovation in risk methodologies. While we recognize the rationale and motivation of the BCBS to ensure orderly progression between the standardized and IRB approaches, especially to prevent banks from gaming the system through selective treatment of exposures, the "all or nothing" requirement raises too high a hurdle to encourage migration from the standardized approach. ABA believes that it will, in fact, slow development of specialized risk modeling techniques, since there is no benefit for partial improvements. Although a general presumption that all material portfolios should migrate to the same approach over time is reasonable, there is a need to allow for justified exceptions, such as to accommodate acquisitions, entries into new markets, new product development or immateriality of some portfolios. National supervisors can assure that banking organizations do not choose IRB treatment selectively, but still be allowed to benefit from more advanced practices where they are in use.

2. The calibration of the internal ratings approach is too conservative.

In consulting with its banks, ABA found a *tentative* correlation between size of institution and anticipated adoption of internal ratings approaches, in that institutions significantly below $100 billion felt that they had neither the resources nor the incentive to invest in the infrastructure to eventually move up to the advanced approach. Additionally, there appear to be built-in disincentives to moving up to the IRB approach. There is a perceived barrier to moving from the standardized to the internal ratings approach in that many banks noted that the foundation IRB capital formula appears to be

steeper than the step function in the standardized approach. For example, non-investment grade credits require much more capital under the foundation IRB method, as credit quality decreases. Because medium-sized institutions are likely to have more of their portfolio in either non-investment grade or unrated corporates, they would be reluctant to accept the additional capital charge plus the additional expense in order to move up to the foundation approach. As discussed above, better granularity, particularly on lower rated corporates, might ameliorate this effect.

The Accord requires a bank to be able to qualify for the advanced approach on an "all or nothing" standard, as discussed above. Even if qualifying for the advanced approach, the Accord imposes a floor of 90 percent of the foundation approach to the banks using the advanced approach. ABA believes that both of these factors taken together strongly disincent banks from moving to the internal ratings advanced approach, which is the ultimate goal of making regulatory capital more closely aligned with economic capital and real risk.

3. The requirement that capital be held for both expected and unexpected losses is misapplied.

The Consultative Paper would require banks to hold capital against all potential losses, those that are expected and those that are not, whether there are reserves against expected losses or not. It must be changed to require capital only against losses that are not expected or reserved for. If capital is to be required against expected losses then the definition of capital must be expanded to include all loss reserves.

The BCBS intends that the Accord will be applicable to all national banking systems and regulatory regimes. Some national regulators require banks to allocate reserves against losses that are expected, and some do not. A universal requirement of extra capital for banks that do set aside reserves against predictable losses would improperly and unfairly penalize these banks. It would undermine the competitive equality and risk sensitivity objectives of the Accord. It would also penalize some normal credit and operating practices for these banks where partial losses are a normal and expected course of business - and as a result, lead to a decline in lending to certain classes of borrowers.

In the United States, banks are required to cover losses that are readily identifiable with reserves against those losses. The reserves serve the place of capital: to absorb the losses when they are ultimately realized. In the case of credit risk, expected losses are reflected as a reduction of capital through a charge to the income statement to fund reserves at the time the exposure is taken on. The same fundamental issues apply to a broader set of businesses in the context of operational risk, where expected losses are routinely built into pricing.

If a second charge is imposed against expected and reserved losses then there would be a double hit on disposable earnings, first when originally provisioned out of earnings then again when added to capital. Higher expected loss businesses, such as credit card and some consumer lending, would be especially penalized. The capital requirements would ignore the fact that such businesses have fairly

stable expected losses and are therefore are less volatile. Reserving banks would therefore have to pass the cost on to consumer in the form of reduced credit at higher interest rates or fees, especially to statistically higher risk groups.

ABA recommends that the BCBS should redraft the Accord to provide that, for banking systems that are required to reserve against anticipatable losses, Tier 1 capital must be sufficient to cover unexpected loss only. If expected losses are to be covered in capital requirements as well then the definition of Total Capital must be changed to reflect all of the resources available for coverage. First, the definition of capital would need to be amended to add reserves and to remove the proposed limit on loan loss provisions. Second, the Accord would need to estimate the loss protection value of highly predictable income streams in Tier 2 Capital, particularly for retail banks.

4. The treatment of collateral and other credit risk mitigation techniques is too conservative.

While strongly supporting recognition of collateral and other credit risk mitigation techniques to reduce the capital requirement embodied in the Accord, ABA's banks believe that recognition of credit risk mitigation is far too conservative in the proposal. With regard to collateral, the Foundation IRB approach only allows financial instruments and real estate to reduce Loss Given Default values ("LGDs"). Other forms of protection provide no relief. If implemented as proposed, this would severely weaken the competitiveness of bank lending to middle-market companies. Security interests such as accounts receivable, inventory, machinery, and equipment are treated as unsecured obligations with a 50 percent LGD and consequently provide little loss reduction in the regulatory framework. Our bankers report that actual historical experience shows this to be much too conservative.

The introduction of a credit conversion factor (20 percent) to commitments with an original maturity of up to one year will alter the cost structure of the existing market for "364 day commitments." Initially at a higher cost, banks will be less willing to extend these facilities. Further, inclusion of this charge renders any of the methods for capital calculation related to credit risk beyond the BCBS's goal of remaining capital neutral. There is no way to include this charge and claim a goal of capital neutrality at the same time.

Finally, there was uniform rejection of the "w" factor and the haircuts on incorporating risk mitigation through collateral, guarantees, and credit derivatives. ABA believes that these misalign risk and regulatory capital. To the extent that they discourage use of credit risk mitigation techniques, they appear to increase rather than decrease risk. Particularly with regard to credit derivatives, our banks believe that the BCBS has misapplied the "w" factor. It appears from the Consultative Papers that "w" addresses legal and documentation concerns that have been addressed through standard documentation agreed to by a number of industry groups. This negative effect is increased by the BCBS's failure to recognize the benefit of the "joint default" position with credit derivatives. In a joint default position, a bank suffers loss only when both the obligor and the guarantor default. When there is a low correlation of default probabilities of the obligor and the guarantor, credit risk is reduced and that reduction should be recognized.

5. The treatment of risk associated with asset securitizations is too conservative.

Most banks concluded that the Accord's proposed capital treatment of asset securitizations would be an improvement over the current treatment. In general U.S. institutions support the "clean break" requirement as consistent with current sale treatment in the U.S., but to the extent that the Accord will impose additional requirements over those currently required by the U.S. Agencies and Financial Accounting Standard No. 140, they suggest that such additional requirements are unnecessary and should be dropped. Banks supported the external ratings approach under both the standardized and Foundation IRB approaches.

However, banks had several reservations about the proposal. First, the Accord treats securitizations differently from corporate debt with no apparent risk difference, resulting in a capital penalty for securitizing banks. The BCBS should maintain that consistency by harmonizing the risk weights between claims on corporate securities and securitization tranches. A securitization tranche rated BB+ should not require a 150 percent risk weight while a corporate security with the same rating only requires a risk weighting of 100 percent. This difference in risk weightings is not justified given the favorable default and downgrade performance of securitizations.

Second, under the proposal, it appears that the aggregate amount of capital applicable to a securitized transaction could be more than the amount of capital required for the loans if they were not securitized. ABA recommends that the BCBS adopt the U.S. Agencies' capital treatment of low level recourse to address this inconsistency.

Third, the Accord would require banks to hold capital (with a minimum 10 percent conversion factor) against assets securitized in transactions that include early amortization features. This appears to disincent banks from better risk management and monitoring. A better approach would be to apply corrective measures to issuers that do not properly manage their securitization programs as part of the supervisory review process in Pillar 2. This would encourage financial organization to incorporate sophisticated internal credit, liquidity and interest rate risk management strategies to evaluate and protect against the risks related to securitized assets. Securitization risks should be evaluated on an "institution by institution" basis as part of Pillar 2 and significant weight should be given to the overall internal risk management practices of that organization. However, if the BCBS insists on requiring capital for assets securitized in transactions with early amortization features, then there should be an acceptable transition period. At a minimum, any new capital requirement should be implemented on a prospective basis and not apply to existing securitizations.

Finally, several of our banks participated in comment letters raising numerous technical issues with the Consultative Paper on Asset Securitizations, including two Multi-Seller Conduit comment letters. We support these more technical comment letters, and urge the BCBS to carefully consider them.

6. The operational risk capital component is arbitrary, undeveloped and not workable.

First, our banks were concerned about the lack of detail on the operational risk component, which made it very difficult to evaluate. However, there were several consistent criticisms: setting the operational risk component at approximately 20 percent of capital appeared arbitrary and not consistent with their own estimates of their operational risk, which were much lower. Second, only a few institutions appear to be actively modeling operational risk, and modeling is very much in development. Third, whether attempting to model operational risk or not, most banks have not captured the data necessary to evaluate operational risk, even theoretically. Several institutions noted that attempts at capturing operational risk utilize historical market and credit losses, resulting in some element of double counting between operational risk and credit and market risk. Uniformly, there was criticism of the BCBS's lack of recognition of business diversity in reducing operational risk.

We are unaware of any instance, other than the collapse of Barings Bank, in which poor management of operational risk was a predicate cause of a bank's failure. That collapse would not have been prevented by the proposed additional operational risk capital charge, but only by a better supervisory approach to the institution's internal controls and monitoring. We do not believe that the proposed quantitative approach to operational risk makes sense, while the BCBS has declined a quantitative approach for interest-rate risk or for other risks that can be quantified more readily than can operational risk.

Only a few banks currently appear to assess operational risk, but they tell us that the operational risk charge is arbitrarily high and at significant variance with the amount of economic capital necessary. Further, the proposed operational risk charge fails to account for the important role of reserves in protecting capital against a risk that is almost always covered through operating income. As discussed above, reliance on high capital charges (as a substitute for supervision) could cause a similar type of regulatory capital arbitrage that the BCBS is now seeking to cure through the changes to the credit risk-based capital rules. Imposition of an arbitrary and onerous operational risk capital charge on banking institutions will make such institutions less competitive in the marketplace for asset management and custody services. And moving these activities outside the more regulated banking group would appear to weaken banks' ability to diversify and remain competitive.

However, there was considerable division between our banks on the best course to take with respect to the proposed operational risk component of regulatory capital. As noted above in the discussion of credit risk mitigation, all of the banks criticized the arbitrary insertion by the BCBS of a "w" factor to haircut the effects of credit risk mitigation. Several banks recommended that the BCBS eliminate the "w" factor, since it was already largely accounted for in the operational risk component. They argue that to do otherwise would result in a double counting of risk and an unnecessarily higher capital requirement. However, more of our banks simply opposed the addition of an operational risk component of regulatory capital in Pillar 1. They urge instead that supervisors move any assessment of operational risk into Pillar 2: the Supervisory Review Process. ABA concludes that the operational

risk component of capital, as proposed by the BCBS, is arbitrary, undeveloped and not workable as proposed. It should be dropped from inclusion in Pillar 1 and instead made part of Pillar 2.

Pillar 3: Market Discipline and Disclosures

The disclosure requirements outlined under Pillar 3 of the New Accord are detailed and extensive. ABA is concerned that the proposal is overly ambitious and would be an enormous burden to the industry without providing commensurate enhancements in risk transparency. As an example of our concerns, we believe that the requirement for mandatory disclosure of detailed risk capital elements (credit risk, operational risk, market risk, interest rate risk) is not appropriate. While we recognize that the objective of providing this information is to foster a greater level of transparency, it is questionable that any additional benefit will be derived from such information. It is also uncertain how individuals and other entities would comprehend or use this information. Banking institutions in the United States already provide substantial disclosures of financial information: additional mandatory disclosure does not appear to be warranted. Attempts to comply with these disclosures will likely confuse users, due to the complexity and differences in application of the proposed disclosures. Although banks might disclose their loan portfolio composition in gross terms, the underlying portfolios themselves may be radically different, especially in the higher risk and unrated categories, creating additional competitive disadvantage. Further, non-bank competitors, not subject to such onerous disclosure requirements, may well be advantaged in public opinion. At a minimum, cost structures for reporting for non-banks would be significantly less than for banks. For example, publicly traded banks and holding companies in the U.S. currently provide an enormous amount of data under the Securities and Exchange Commission’s and Agencies' rules, resulting in disadvantageous reporting as compared to privately held companies, to banks outside of the U.S. and to non-bank competitors.

Thus, ABA is concerned that the proposal will produce informational overload with strongly negative implications for banking groups. Further, many banks were concerned that the proposed Accord requires disclosure of so much detail that confidential customer data and proprietary competitive data would necessarily be exposed. As an alternative, ABA notes that there are disclosure initiatives under way in the U.S. at both the Federal Reserve Board (FRB Working Group on Public Disclosure) and the American Institute of Certified Public Accountants (Loan Loss Task Force). ABA believes that the BCBS should recognize these efforts and coordinate the Pillar 3 requirements with them. Overall, ABA recommends that the BCSC focus its efforts on bringing disclosure standards for internationally active banks to the level which currently exists in the U.S. Any additional disclosure should be required only on a supervisory basis, or if demonstrably beneficial to investors.

Conclusion

The American Bankers Association appreciates the opportunity to comment on the proposed Accord. While ABA believes that the BCBS has made significant progress in improving the current Accord, ABA believes that much work remains to be done and that another round of Consultative Papers is required before a final new Accord may be achieved. ABA is particularly concerned that the calibration of the standardized and IRB approaches is too conservative and that the proposed operational risk component not be made part of Pillar 1 but must be moved into Pillar 2 of Supervision.

Sincerely,

Paul A. Smith