

31 May 2001

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Board of Governors
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Secretariat
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Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/OES
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Communications Division
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219
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Re: The New Basel Capital Accord

Dear Mesdames and Sirs:

America's Community Bankers ("ACB")¹ welcomes the opportunity to comment on the proposed New Basel Capital Accord (the "Accord") developed by the Basel Committee on Banking Supervision at the Bank for International Settlements ("Basel"), as well as the January 23, 2001 interagency summary of the Accord issued by the United States Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency (the "OCC") (collectively, the "Agencies"). The Accord represents an international supervisory effort to describe the methods for establishing minimum regulatory capital requirements.

ACB Position Summary

ACB agrees with the approach of Basel in linking minimum capital requirements with an institution's risk profile. And, we believe that the Accord may offer some institutions the potential for increased flexibility in determining capital levels, which could enable certain institutions to deploy capital more efficiently.

¹ ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

It is important to note at the outset that, while the 1988 Accord was intended to apply only to internationally active banking organizations, United States banking supervisors elected to subject all U.S. financial institutions to the Accord's requirements, regardless of size or complexity. Since that decision, the U.S. financial services market has adapted to the Basel system of capital regulation, even as the industry continued to consolidate. Today, many smaller, publicly traded institutions compete with their global counterparts under the same rules.

Fundamentally, ACB believes that the Accord offers far too few benefits for community-based financial institutions in the United States. At the same time, the proposal would impose, if adopted in the United States, a disproportionately burdensome and overly complex system of capital regulation on community banks. In short, the Accord will benefit only the most complex and internationally active banks, saddling the vast majority of financial institutions in the United States with a cumbersome and expensive capital regulatory scheme that increases compliance burdens without offering any real prospect for fine-tuning capital levels as measured against risk.

Our concerns are most pronounced with respect to Pillar I of the Accord and its approaches to minimum capital requirements. ACB believes that the proposed bifurcation between the Standardized and internal ratings based ("IRB") approaches to establishing minimum capital requirements will competitively disadvantage many smaller banking institutions that lack the resources necessary for developing a finely calibrated IRB assessment system. With respect to other aspects of Pillar I:

- ACB opposes assigning a risk weighting of 20 percent for obligations of public sector or government sponsored enterprises.
- We believe that the risk weighting of financial assets should be uniform, regardless of whether a Standardized or IRB approach to capital assessment is employed.
- Additional refinements to the proposed risk weightings for claims secured by real property are necessary. Lower loan-to-value ratios should translate to lower capital charges.
- The proposed treatment of collateral under the credit risk mitigation provisions is unduly restrictive and should be revised substantially.
- The proposed approach to asset securitizations would not reflect the true impact of an effective transfer of risk. Substantial revisions are needed in this section.
- The Accord's approach to operational risk assessment and resulting capital charges is too focused on a small population of global, internationally active banks and their higher than average operational risks.
- ACB encourages a uniform approach to interest rate risk capital requirements.

With respect to smaller, publicly traded banking organizations, ACB believes that, if subject to the Accord as proposed, these institutions could suffer from a perceived degree of decreased market transparency because these institutions either do not possess the resources necessary to develop an IRB system for assessing their capital, or have business models that would make the costs associated with such a system unreasonable in relation to expected benefits. This class of banks would be disadvantaged further still as a result of potential overcapitalization in many

instances vis a vis competitors that employ an IRB approach to capital assessment and enjoy the resulting potential for more tailored, i.e., reduced, capital requirements. While the Accord states that the goal is not to change capital levels overall, in fact ACB believes that many community banks will end up holding higher capital under the Accord as compared with global and potentially more risky institutions.

Procedurally, ACB believes that the volume and scope of the Accord is so extensive as to make finalization and implementation in the near future highly undesirable and impracticable. We believe that any “final” version of the Accord should be subject to an additional review and comment period. To do otherwise is to discourage thoughtful analysis and meaningful comments on this most complex of proposals.

For the reasons set forth in this letter, ACB does not support the Accord in its current generation.

Overview of the Accord

The Accord is comprised of three mutually reinforcing “pillars” that are designed to create a framework for assessing capital adequacy in banks.

Pillar I – Minimum Capital Requirements: This pillar includes both a Standardized and two versions of an IRB model for determining minimum capital requirements. This pillar includes significant changes from the 1988 Accord and comprises the majority of the Accord. Essentially, the Accord contemplates a minimum capital charge of eight percent, which would be derived using a formula taking into consideration an institution’s:

- Risk-weighted assets (credit risk);
- Market risk capital (trading risks);
- Operational risk capital; and
- Interest rate risk capital charges.

Pillar II – Supervisory Review: The second pillar of the Accord encourages banking supervisors to assess an institution’s internal approaches to capital allocation and internal assessments of capital adequacy. Regulatory agencies are guided as to what capital assessment procedures and policies should be utilized by supervised institutions, and what steps are necessary by supervisors to ensure appropriate levels of capital, particularly with respect to institutions that employ an IRB approach.

Pillar III – Market Discipline: Because market discipline has the potential to reinforce capital regulation and other supervisory efforts, this pillar includes a number of disclosure initiatives aimed at making the process of determining capital adequacy more transparent.

Taken together, the three pillars of the Accord are designed to produce a more finely tuned level of minimum capital across institutions throughout the world. As currently proposed, the Accord would be finalized during 2001.

ACB's Concerns

As noted above, ACB believes that the Accord's approach to determining minimum capital requirements favors only those institutions with significant and, in many instances, well established infrastructures necessary for internally analyzing, determining and calibrating necessary capital levels based on overall and specific risk factors. The remaining population of financial institutions will be required, if adopted, to utilize a Standardized approach or incur significant costs in establishing an IRB system. This will, in turn, result in a competitive disadvantage for many, particularly community-based and smaller financial institutions, the capital levels of which will necessarily be higher than their global competitors employing a potentially more precise IRB system.

Pillar I – Calculation of Minimum Capital Requirements

While ACB notes that some aspects of Pillar I may represent an improvement over current capital regulations, there are a number of troubling aspects to the proposed standards for establishing minimum capital requirements.

Credit Risk Components

Risk Weights for Public Sector Entities (“PSEs”): ACB does not support the proposed risk weighting of 20 percent for obligations of PSEs or, as commonly known in the United States, government sponsored enterprises (“GSEs”). ACB believes that GSEs within the United States serve an important mission: particularly facilitating and encouraging the development of housing markets. At the same time, we believe it is important for GSEs to operate within the bounds of their congressionally established missions. As such, we do not favor the treatment of GSEs in a manner similar to traditional corporations because we do not favor their corresponding transformation from limited-purpose, congressionally directed enterprises. The Accord notes that national supervisors may elect to apply a zero weight to some GSE/PSE debt, and ACB encourages the Agencies to adopt this stance.

Risk Weights for Banks: ACB generally supports the proposed adoption of a 20 percent risk weight (a floor) for the obligations of banks and depository institutions. We believe, however, that there is a heavy reliance on ratings from external credit assessment institutions (“ECAIs”) in assessing banks that would generally favor banks that have obtained a rating from an ECAI. Smaller banks that do not regularly issue public debt securities often cannot justify the cost of obtaining an ECAI rating. We encourage the Agencies to consider that some distinctions be made in the risk weighting of unrated banks in the United States. Moreover, because information on capital adequacy ratios is available for banks via U.S. banking supervisors, we believe that capital adequacy ratios would provide a superior method over ECAIs for banks to attribute interbank credit risk. Moving towards a system that gives undue weight to ECAIs may not be beneficial to liquidity in the financial system.

Risk Weights on Corporate Claims: ACB supports the adoption of varying risk weights on corporate exposures. Because the weight for unrated corporate obligations essentially is unchanged, lenders to smaller, unrated corporate obligation issuers are not disadvantaged.

Risk Weights on Retail Assets: The Accord does not offer a proposal on the weighting and methodology for the treatment of retail assets. Rather, Basel seeks guidance on the treatment under the IRB approach and how this might apply with the Standardized approach. ACB believes that the treatment of retail assets generally should be the same for all banks, regardless for whether they generally are using the IRB or Standardized approaches.² Because retail assets differ in performance so markedly, it is imperative that bankers be able to develop risk weights appropriate to the types of exposure they hold. We are particularly concerned with the treatment of residential mortgage loans, and ACB urges the Agencies to consider that the values of collateral and mortgage insurance are available as mitigants against the credit risk exposures in mortgage portfolios. As currently drafted, the Accord contemplates that only corporate (and some commercial real estate) exposures can directly benefit from physical collateral.

ACB believes that an appropriate framework for retail asset risk weightings would allow banks to segment retail assets by product, borrower and other characteristics and apply an empirically determined expected loss (“EL”) or an estimated loss given default (“LGD”) to the portfolio segments in calculating capital requirements (the EL or LGD estimates could come from a combination of internal and external sources). The EL and LGD estimates would implicitly reflect the value of physical collateral (across loan-to-value (“LTV”) segmentation, for example).

If an IRB-type approach is not deemed suitable across all banks' retail portfolios, we would suggest bifurcating retail portfolios into assets that have physical collateral and those that do not. The mitigation of credit risk from physical collateral and financial guarantees for mortgages and certain other retail assets should be at least as permissive as that which is contemplated for corporate obligation exposures. Besides the obvious need to account for the benefit of physical collateral, retail exposures that have physical collateral - residential mortgages and automobiles - typically have longer contractual maturities and longer effective economic lives than do many other retail assets, so a separate maturity treatment could be applied to these assets, rather than assuming that the entire portfolio has a three year maturity.

Risk Weights on Claims Secured by Residential Property: The proposed 50 percent risk weight against residential property exposure is comparable to what is in place now. We would suggest that an additional provision be made within the Standardized approach so that more buckets and risk weights are available on residential assets. Residential loans can vary tremendously as to risk exposure. Factors such as the loan's LTV ratio have a pronounced effect on both the probability of default (“PD”) and the LGD of residential loans. Thus a loan with a 60 percent LTV should require considerably less capital than a loan with an LTV of 95 percent or higher. As the proposal stands, only those banks that use the IRB approach will be able to use credit

²The proposal notes that there is no difference contemplated between the foundation and advanced IRB approach vis a vis retail exposure. This augments the argument that the approach to retail exposure should be uniform across all depository institutions.

mitigation factors related to LTV to lower their required risk weights against residential exposures, and ACB urges the Agencies to create additional opportunities to make better distinctions in the capital treatment of residential loans.

Risk Weights on Claims Secured by Commercial Real Estate: While ACB generally supports the proposed approach to the treatment of commercial real estate lending, we suggest that the proposed restriction of 0.5 percent of total commercial real estate losses is unrealistically low. Due to market cycles, a one-year loss rate of 0.5 percent does not necessarily suggest a near doubling of required risk capital, as is contemplated in the Accord. U.S. depository institutions already are subject to rules for recognizing impairment, are examined frequently, and have outside independent auditors. All of these mechanisms help ensure disclosure of whether or not impairment of asset values is occurring in a commercial real estate portfolio. If systematic impairment were occurring, this would cause an increase in allowances for loan losses and a concomitant decrease in asset values. We oppose this element of the Accord.

Additionally, the proposal notes that this reduced risk weight (from 100 percent to 50 percent) is only available on certain office properties or multitenanted commercial premises. ACB encourages U.S. banking supervisors to broaden the list of eligible project types and provide guidance as to what types of properties are deemed to be "multitenanted." We believe it would be a mistake for regulatory capital treatment rules to apply more favorable treatment toward only the largest of commercial real estate lending projects. The loss history of the last 20 years in the United States has demonstrated that loans on large office towers and large multitenanted project are not necessarily any less risky than smaller commercial real estate loans.

Credit Mitigation Under the Standardized Approach

ACB's analysis of the proposed comprehensive approach to credit risk mitigation ("CRM") raises significant concerns because the Accord suggests applying mark-to-market haircuts to financial asset collateral values and, thus, allowing for only partial benefits from a very short list of eligible collateral. ACB urges the Agencies to take care to avoid the possibility that valuable bank assets – which are available as contingent capital – would be excluded from available regulatory capital through the combined treatments of credit risk, trading and interest rate risk models set forth in the Accord.

Collateral: The proposed treatment of collateral is very restrictive and, thus, allows banks only a small regulatory capital benefit for using collateral to protect against losses. One particular example involves the use of closed whole mortgage loans used as collateral in mortgage warehouse lending. While mortgage loans trade in a large, highly liquid market and are one of the most widely used forms of collateral for financial instruments, a warehouse lender lending to a mortgage banker would receive no benefit for this fully collateralized loan under the proposal. U.S. banking supervisors should include provisions in any final capital standards confirming that certain types of loan collateral are eligible for CRM.

The proposed definitions for allowable physical collateral exclude the collateral of virtually any corporate borrower that participates in the real estate or real estate lending business. If real estate-related loans can be classified as "retail," it appears that some mitigation of capital attribution may be available from segmenting lower LTV loans into lower EL segments, but no corresponding relief is available for businesses relationships that are not so small as to be retail loans. Under the Accord, the physical assets that secure lending to many small and medium sized businesses are in danger of being excluded from the design of relevant credit weights. ACB would suggest that U.S. bank regulators modify the proposal to allow banks some benefit from the physical capital that is available to protect the bankers that lend to real estate developers, home builders, income producing property owners, farmers and many other business.

We support the notion of having a carve-out for well-documented repurchase transactions where a haircut is not required on the collateral and the risk weighting of the financial instrument drives the risk weighting of the collateralized transaction.

Lastly, we believe that the Accord's proposed requirement of annual legal opinions regarding the enforceability of collateral is unnecessarily burdensome and costly, and should be eliminated in any final version.

Guarantees: ACB generally supports the Accord's approach of allowing direct substitution of insurer and guarantor risk weights when utilized to reduce credit risk, but we note some concerns regarding the proposed language for minimum requirements for use of guarantees in CRM, including requirements that guarantees (such as insurance) must be irrevocable and unconditional. Most guaranty and insurance agreements typically contain language regarding representations and warranties of the parties to the agreement, and certain grounds such as fraud or misrepresentation by the bank or obligor may render a guaranty invalid or revocable. The rare occurrence of such situations should not prohibit or taint the use of this effective CRM tool.

Additionally, under the Accord, the proposed treatment does not allow for "pure substitution" of a guarantor's risk weight (unless that guarantor is a sovereign or zero-weighted PSE), but instead "haircuts" the insurance/guarantee coverage amounts by 0.15. Thus, if a bank, or its obligor, purchases mortgage insurance that provides first loss coverage on a loan, the bank will receive only 85 percent of the benefit of coverage for purposes of calculating regulatory capital. We believe that this is excessively conservative and methodologically inconsistent. If an AA-rated mortgage insurer, for example, offers a bank the ability to substitute a 20 percent risk weight applicable to the insurer for the first loss piece on the mortgage, then the bank should fully receive that benefit to its economic capital. The AA rating, or whichever rating the insurer obtains, should reflect the likelihood that the insurer itself may default, so an additional 15 percent haircut is duplicative and without sound justification. ACB notes, as well, those cases where a lender is receiving guarantees from several insurers. Under this scenario, applying an across the board 15 percent haircut assumes that there is no benefit to diversification, e.g., that the insurers are equally likely to default simultaneously.³

³We would note that one of the most highly regarded resources for credit risk modeling - CreditMetrics - estimates that the joint probability distribution of a single A and a BB obligor defaulting simultaneously (with a significant

Other Comments on the IRB: Under the foundation approach to the IRB model, banks will be able to develop an empirically based PD and rely on supervisors to apply LGDs to particular types of exposure in order to calculate risk weights. The LGDs described in the Accord appear to be overly conservative. Again, the value of collateral is circumscribed for many valuable types of collateral. And, for those permitted types of physical collateral, the benefits of relying on collateral are given little weight. The foundation approach allows for reductions in the LGD from 50 percent down to 40 percent for low LTV loans (LTVs of less than 71.4 percent). This lowered LGD is applied only to the collateralized portion of the loan. A simple example might illustrate how this proposal understates the value of physical collateral: a loan with an LTV of 60 percent would have a LGD of 40 percent on the collateralized portion; a loan with an LTV of 100 percent would have a LGD on the collateralized portion of approximately 43 percent. Thus, under the proposed formulae, increasing the LTV ratio of a loan by 66 percent (from 60 percent to 100 percent LTV) increases the supervisory LGD by only 7.5 percent (from 40 percent to 43 percent). This example is illustrative of the short shrift that is given collateral in the proposal. We would urge the Agencies not to adopt this overly restrictive approach.

Many proposed requirements for data collection and storage will make use of both the foundation and advanced IRB approaches difficult and expensive for smaller community based institutions to implement. We would suggest that banks be allowed to use external mapping provided by vendors and participants in secondary markets for loans. Smaller banks should be allowed to obtain the benefits of using vendor software and external databases to implement the foundation and even advanced IRB approach. The barriers to entry to the adoption of IRB modeling should not consign small banks to what is effectively a supervisory requirement that they be overcapitalized compared to the larger financial institutions against which they compete. One example of the high costs of using IRB, for example, is the requirement that banks maintain a complete ratings history for each borrower. Such a requirement will raise loan administration costs and force banks that lend to small businesses to either implement onerous record keeping requirements or elect that retail exposure capital treatment be applied to small business loans.

Asset Securitization

ACB believes the following principles are not well represented within the Accord's proposed treatment of asset securitizations. The Agencies should consider these guidelines in any deliberation of how to implement the Accord in the United States.

- A bank that is selling assets into a securitization should not hold more capital than if it had retained the exposure on its balance sheet.
- A bank that has a continuing involvement with the management of assets in a securitization is not necessarily providing credit support. Sponsoring or issuing banks should not be required to hold capital for credit risk exposure if simply engaged in the ordinary course of servicing and managing the assets. This activity would involve

amount of asset correlation between the obligors) is less than one percent over a one year time horizon. See Credit Metrics - Technical Document, dated April 1997.

advancing funds, transferring assets to special servicers, and engaging in loss mitigation activities on behalf of the investor.

- The credit risk weights should reflect credit factors only. Some of the Accord language related to holding capital against a securitization appears to be related to a concern that a bank will not be able to transfer new credit exposures (e.g., credit card receivables, working capital loans) into an existing or terminating revolving trust. Regulatory concerns about liquidity are most appropriately addressed in the supervisory process and within interest rate risk regulations. We believe that supervisory guidance regarding asset liability and interest rate risk management should continue to be the appropriate mechanism for addressing liquidity exposure concerns.
- The Accord's treatment of retention of first loss exposure is excessive, as even the authors of the Accord note. The treatment would require deduction of the entire exposure amount from capital, as if the first loss tranche will be fully consumed by expected and unexpected losses. ACB opposes this approach and urges the Agencies to reject this analysis, as well.
- We support the notion of "looking through" to the underlying collateral for senior pieces of unsecured transactions as an appropriate approach.

Operational Risk

While the Accord shows some improvement over Basel's previous announcements with respect to operational risk, ACB nevertheless objects to several elements of the approach the Accord would require. Operational risk is an area where internationally active banks take considerably more risk than do domestic, community based organizations. The proposed approach, which is designed for internationally active banks, uses data regarding their level of operational risk and pushes this estimate down to the remaining population of banks. These banks are less likely to engage in large-scale fee generating activities, including payment and transfer or corporate trust, which create the large attribution of operational risk capital in the first place.

There is an inherent inconsistency in the proposed approach taken in the Accord. Basel notes that its Basic Indicator and Minimum Risk Capital ("MRC") floor (30 percent of income, and 20 percent of minimum regulatory capital, respectively) are calibrated based upon a sample of internationally active banks - typically universal banks that engage in a wide variety of fee generating activities. At the same time, the proposal states that primarily smaller domestic banks will ultimately use the Basic Indicator. ACB does not support this approach and is concerned about both the Basic Indicator approach and the MRC floor. Applying a basic indicator, based on gross income, for example, puts all banks into the same category regardless of how the banks derive their income, the volatility of that income, or what exposures to various operational risks might be. If a Basic Indicator approach is used, the basic indicator should be derived from an attribution of operational risk capital to commercial and retail banking, i.e., lending and deposit

taking, and, while a handful of banks do not engage in retail or commercial banking, we would advocate that U.S. bank regulators design such an indicator for the majority of banking institutions that do primarily focus on traditional banking and will rely most heavily on the Basic Indicator.

The Standardized Approach attempts to address some of these major flaws in the Basic Indicator approach. Attributing operational risk capital to lines of business addresses many of the problems inherent with the Basic Indicator, but some of these concerns remain because of the artificially high floor of 20 percent of dollar MRC. We believe it is a mistake to set a floor *at* the industry average, particularly if that average is calibrated based on institutions that have above average exposure to operational risk in general. If the rationale of the Accord is to move regulatory capital closer to the actual economic capital attributed to risk, then over-attributing capital to operational risk is not a move in the right direction.

The Internal Measurement approach allows some institutions to lower their required capital if the data exist to support a lower attribution. We fully support an institution's ability to manage its capital efficiently if there is sufficient empirical evidence that lower operational risk capital is warranted. Regulators will need to develop definitions of what is an operational risk loss event and what is a sufficient basis of historical loss information, as well as insuring disclosure of this information to the public securities markets. We support the concept of a floor for capital attribution using the Internal Measurement Approach, but with the modification that the 20 percent MRC floor be revised substantially or eliminated. Thus, an appropriate floor for the Internal Measurement approach might be 90 percent of the results of the Standardized approach. Alternatively, the floor could be based on the confidence interval around the estimates of average capital from the Standardized approach. The confidence interval, assumed distribution, and time horizon for calculating the floor could be determined by better empirical work on the subject.

In summary, ACB opposes a Basic Indicator in general and, in particular, a Basic Indicator derived only using data for international "money-center" banking institutions. The Standardized approach might be the best approach for all institutions, but it is best applied without an overriding floor (20 percent of MRC). An empirical basis for the Standardized approach could be provided to the banking industry and banks can either use that or invest in development of an Internal Measurement approach. The averages from the Standardized approach, and variances of these estimates would then serve as a basis to set a floor for lowering required operational risk capital.

Interest Rate Risk Capital Requirements

As the Agencies know, banking supervisors in the United States have, after several years of deliberation, decided not to pursue an interest rate risk ("IRR") capital charge within the existing risk-based capital framework. The Office of Thrift Supervision, the only banking agency that developed rules for implementing IRR capital charges, has recently proposed rescinding this regulation. Regardless of whether the Accord is adopted in the United States, ACB believes that there should be uniformity in the treatment of IRR across all institutions, for both supervisory purposes (e.g., CAMELS ratios) and for any IRR capital charges.

ACB does support the Accord's proposal to allow banks to use their own models to measure and manage IRR. These models could, of course, be vendor models modified for the bank's internal adjustments. The Agencies may wish to develop standards for such models, so that banks can know what is expected from such models.

ACB generally supports the Accord's approach of using total capital as the metric by which to gauge the effects of an IRR shock. Total capital is a more transparent calculation than using a "black box" calculation of economic capital. Because total capital is a widely understood concept, institutions would be better able to explain their IRR metrics and strategies to directors, investors, and other interested parties.

Lastly, ACB urges all supervisory agencies to maintain the clear distinctions between what is credit risk and what is IRR risk. Several items within the Accord, and even some recent and proposed U.S. banking regulations, attempt to apply higher credit risk weights to assets that are largely exposed to IRR, with little inherent credit risk. One example is the 100 percent risk weight assigned to stripped mortgage-backed securities. Many of these securities exhibit credit risk exposure that should properly be in the 0 percent or 20 percent risk weights. The potential loss exposure of these instruments is due to interest rate and prepayment volatility, which should be addressed in IRR management. An additional example would be adjustable-rate mortgages that have potential exposure to negative amortization. Such an increased loss exposure is driven by interest rate volatility. If a proper framework for IRR is in place, negative amortization adjustable rate mortgages ("ARMs") would "cap out" sooner than other ARMs, thus limiting their value as post-shock assets. If U.S. banking regulators adopt a IRR capital charge, then great care should be taken not to overburden rate-sensitive assets with unnecessarily high credit risk weightings.

Pillar II – Supervisory Review Process

The Accord includes four key principles to supervisory review by banking regulators:

- Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.
- Supervisors should review and evaluate banks' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.
- Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

- Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

In their January 2001 release, the Agencies asked whether these principles provide a sufficient basis for a consistent approach to supervisory review processes, including valuation of minimum standards for participation in the IRB approaches. Generally, ACB believes that these principles are consistent with current practices employed in the United States under the current system of capital regulation, but we would caution the Agencies to take particular care in applying the Accord's principles to institutions that may employ an IRB approach under the Accord. Because these institutions potentially will enjoy significant competitive advantages, only those institutions that truly are qualified to set their own capital levels, as confirmed by U.S. bank supervisors, should be allowed to enjoy this freedom.

As well, against a backdrop of focus on internationally active institutions, it is important to remember that most community banks in the United States are well run and well capitalized. Arguably, many smaller community banks tend to be overcapitalized. If adopted, the Accord could result in these institutions losing out to competitive and economic opportunities because they cannot avail themselves of the new IRB approach. Community banks are foundations in cities and towns across the country and the Accord should not produce two classes of financial institutions: those complex enough to take advantages of efficient capital deployment techniques and those forced to maintain higher than necessary capital and unable to more effectively serve their communities and otherwise deploy their capital.

Pillar III – Market Discipline

Pillar III contains a number of recommended disclosures aimed at improving market discipline. ACB supports this goal but we remain concerned about disparate treatment among those institutions that are publicly held.

For institutions that employ an IRB model to capital assessment and which are allowed to lower their overall capital assessment, we believe these institutions should be required to publish annually what their capital charges would be under the Standardized approach. This will aid in the transparency efforts contemplated by the Accord. This is particularly important as institutions may well be employing a wide variety of IRB models to their capital assessment. As noted earlier, a number of smaller publicly traded institutions operate under the same rigorous market demands as their global counterparts. Nevertheless, many of these institutions lack the resources to develop such complicated internal ratings systems as are contemplated by the Accord. These institutions may well face negative market reaction to a perceived lack of transparency, despite the fact that these banks are well run, well managed and serve their particular shareholder interests well. The Accord includes no consideration of this segment of the U.S. financial services market. Rather, Pillar III is designed around the internal databases that exist in only the most complex of global financial institutions. Market discipline and transparency will operate effectively only if applied across the banking sector and not just among

a few select institutions. ACB urges Basel and the Agencies to consider these concerns in any move forward on the Accord.

Conclusion

In summary, ACB opposes the Accord in its current formation because we believe it represents significant regulatory burdens for most community banks, could competitively disadvantage many institutions and will not enable the majority of U.S. banking organizations to manage their capital levels more effectively and efficiently.

ACB appreciates the opportunity to comment on this important proposal. We stand ready to assist in any way possible in developing meaningful, yet less burdensome, capital regulations for community based institutions throughout the United States.

If you have any questions, please contact the undersigned at (202) 857-3121 or cbahin@acbankers.org, or Michael W. Briggs at (202) 857-3122 or mbriggs@acbankers.org.

Sincerely,

Charlotte M. Bahin
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