May 30, 2001

Mrs. Daniele Nouy
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002, Basel, Switzerland

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW, Washington, DC 20429
Attention: Comments/OES

Ms. Jennifer J. Johnson
Federal Reserve Board
Basel 2001 Capital Proposal
Mail Stop 179
21st and C Streets, NW
Washington, DC 20551

Re: New Basel Capital Accord

Dear Sir and Mesdames:

CSBS is pleased to have the opportunity to respond to the Basel Committee on Banking Supervision's ("Committee") request for comment on the new Basel Capital Accord ("Accord"). CSBS is the national organization of state officials responsible for chartering, regulating and supervising the 6,868 state-chartered commercial and savings banks and 419 state-licensed branches and agencies of foreign banks in the United States.

Our comments are based on the premise that capital and reporting rules should be commensurate with the size and complexity of an institution. Furthermore, we believe that some components of risk management are difficult to capture by even the most precise mathematical calculations. Under certain circumstances, it may be more effective

to evaluate some components of an institution's risk management program through the supervisory process.

Potential Disparate Impact

CSBS commends the Committee's efforts to develop regulatory capital requirements for large, internationally active banks in a manner that permits them to utilize their own internal risk management systems. The Accord is a complex series of formulas for deriving capital needs, coupled with supervision and disclosure protocols. We believe that without further pilot testing, it is uncertain whether the Accord's complexity will be offset by the benefits achieved through aligning an institution's capital needs closer to its risk profile.

We further believe that applying the Accord to institutions such as community banks that do not have the same risk profile as large, internationally active institutions imposes a costly and unnecessary compliance burden. Therefore, CSBS disagrees with the Committee's assertion that the underlying principles of the Accord are suitable for application to all banks, regardless of their level of sophistication and complexity.[1] We note that the U.S. Federal Regulatory Authorities share our concern.[2] For example, the Accord's framework includes incentives for institutions to develop sophisticated in-house computer modeling software. It may be impractical for a non-complex institution to develop an internal ratings system with the level of sophistication necessary to satisfy the Accord's requirements. Moreover, such a sophisticated system may be disproportionate to the business plans of many community banks. Because simpler standards in both instances may be more appropriate than a complex internal ratings system, CSBS suggests that for these institutions, existing leverage-based capital standards suffice.

Supervisory Pillar

CSBS commends the Committee for focusing on qualitative improvements in operational risk management in tandem with developing specific quantitative measures. CSBS supports the Committee's efforts to assist bank supervisors in evaluating the overall portfolio risks of institutions, and when necessary, requiring institutions to hold additional capital. However, CSBS believes that the Accord's Pillar Two – the supervisory review process, lacks clarity in terms of how supervisors should review some of the significant components of Pillar One – the minimum capital pillar. This is particularly troublesome given the Committee's observation that bank examiners may have difficulty evaluating the accuracy and coverage of subjective internal ratings and comparability among institutions. This lack of specific supervisory guidance, coupled with the difficult task of evaluating subjective ratings systems, could lead to the unfortunate result of inconsistent, or worse, faulty supervisory judgments.

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[1] Id.

[2] Summary of the Basel Committee's: The New Basel Capital Accord, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, 2. (Jan. 23, 2001).

CSBS appreciates the broad philosophical principles outlined in Pillar Two of the Accord. However, CSBS urges the Committee to refine the Accord by articulating more specific detailed expectations. Better still, CSBS requests that educational guidance and training programs be developed in conjunction with the Accord. CSBS also believes that the extent to which the Accord makes sweeping revisions to capital calculation requirements, supervisory education and training is critical. CSBS suggests that before finalization and implementation, the Committee should include in the Accord a framework for the initial approval of a bank's internal ratings system. In conjunction with this framework CSBS also suggests that the Committee clarify the procedures or factors to include in subsequent rating system assessments. This will enable supervisors to critically examine risk management and capital allocation processes and techniques in a manner that allows for diversity in the conceptual make-up and practical application of different models.

Operational Risk

One of the significant changes in the new Accord is the requirement for banks to hold capital for operational risk. CSBS commends the Committee's attempts to fine tune risk-based capital requirements. The Committee's effort to accurately quantify operational risk is commendable especially in light of the difficulties in defining and calculating such an elusive concept. Nevertheless we believe the Committee fell short of its goal. The Accord defines operational risk as "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events."[3] CSBS is concerned that this definition and the calculations used to quantify it are overbroad and vague. In fact, the calculations appear to double count some elements of credit risk, possibly resulting in an invalidation of some credit risk data. For example, items such as losses resulting from poor credit documentation are within the proposal's definition of operational risk, while a bank historically may have included them in its credit loss data.

We support the principle of risk-based supervision and believe that institutions should implement plans to minimize operational risk. We also believe that it is possible to identify characteristics of effective operational risk management programs. Active and responsive management, clear reporting lines, accurate and timely management information, and management strength are but a few examples of factors that reflect appropriate operational risk management programs. Nevertheless, these factors are difficult to quantify with any degree of certainty. We therefore ask the Committee to consider whether operational risk may be more effectively addressed through the supervisory process and market discipline, the second and third pillars of the Accord, instead of formulaic capital rules.

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[3] The New Basel Capital Accord Consultative Document, 94 (Jan. 2001).

Clarify Rationale

A further concern CSBS has with the Accord is its minimal documentation for the underlying rationale of the Accord's risk components. The result is less than optimal transparency on how the components and formulas were derived. CSBS suggests that incorporating additional background methodology would increase the Accord's level of transparency, thus making it easier to understand and implement. The Accord is a comprehensive document incorporating a multitude of complex calculations. While we recognize the Accord's already daunting size and scope, we believe the benefits gained from additional documentation offset the minimal complications arising from increasing the document's length.

Impact on Corporate Transactions

CSBS also requests that the Committee consider the Accord's potential impact on corporate transactions such as mergers and acquisitions. The Accord's incentives for institutions to develop more sophisticated (i.e. complex) risk measurement systems could result in some institutions, particularly larger institutions, developing more advanced methodologies while less complex institutions opt for comparatively simpler risk management approaches. As a result, it may be difficult to value smaller, noncomplex institutions, thereby complicating merger or acquisition transactions. Blending disparate risk management techniques due to a merger or acquisition may also prove difficult. To avoid these potential consequences, CSBS suggests that the Committee evaluate the likelihood that the Accord will inhibit corporate transactions, and if so, consider developing methodologies to minimize this impact. For example, the Committee could consider establishing a framework for merger or acquisition transition periods.

Conclusion

Thank you for this opportunity to comment. Please call on us if you have any questions or if we can provide additional assistance.

Best Personal Regards,

Neil Milner
President and CEO