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Basel Committee on Banking Supervision
Secretariat
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: January 2001 Proposal Regarding The New Basel Capital Accord

Dear Ladies and Gentleman:

The Institute of International Bankers is an association that represents the interests of internationally headquartered financial institutions that conduct banking, securities and/or insurance activities in the United States. On behalf of our member institutions, we appreciate this opportunity to comment on the Second Consultative Package issued in January 2001 by the Basel Committee on Banking Supervision regarding the proposed New Basel Capital Accord (the "New Accord").

OVERVIEW AND EXECUTIVE SUMMARY

While the Institute strongly supports the Committee's efforts to develop a new capital framework that facilitates a more comprehensive and risk-sensitive approach to setting minimum capital requirements and permits the allocation of capital on the basis of a banking institution's internal risk assessments, we are concerned that the Committee's overall objectives will not be met as currently proposed. The Institute is also concerned about the feasibility of the timetable being pursued and the potentially heavy cost burden of implementation. However, as many of these questions are the subject of detailed and specific comments submitted by our individual member institutions, this letter focuses specifically on only the following three aspects of the New Accord.

Responsibility of Home Country Authorities for the Supervisory Review Process under Pillar 2

Consistent with the Basel Concordat and the Core Principles for Effective Banking Supervision, we recommend that the Committee clarify that a banking institution's home country supervisor has primary responsibility for oversight of matters relating to the institution's capital

so long as the home country supervisor oversees the operations of the institution on a consolidated basis in accordance with international standards.

It is not intended that primary role of home country supervisors exclude host country supervisors from any role with regard to capital adequacy questions. As a key indicator of a banking institution's financial strength, capital adequacy is a matter of continuing supervisory concern to both home and host country authorities. It is important to strengthen the dialogue between home and host country supervisors regarding a banking institution's capital. It is equally important to avoid subjecting an institution to a multiplicity of potentially conflicting host country requirements, which would be extremely disruptive to a banking institution's risk management processes and impose substantial additional costs (e.g., for duplicative management information and reporting systems). While it is necessary to address any concerns a host country supervisor may have regarding a non-domestic banking institution's fundamental safety and soundness, the judgement of the home country supervisor regarding an institution's capital adequacy as a legal entity on a global basis generally should be respected.[1]

Moreover, the Committee should clarify that as a general supervisory matter the determination of whether a banking institution's capital should be greater than the minimum required under the New Accord and, if so, what that greater amount should be is the sole responsibility of the home country supervisor.

It is recognized that in certain circumstances (for example, as in the United States) host country law may (i) restrict the authority of banking institutions (whether domestic or non-domestic) to engage in certain types of activities in the host country to those that maintain capital in excess of the minimum required under the New Accord and (ii) direct the host country supervisor to make a determination on the adequacy of non-domestic institutions' capital for these purposes. We believe that in these circumstances a host country supervisor should consult with the institution's home country supervisor and make its determination by utilizing home country standards (so long as such standards are consistent with international standards), taking into account any adjustments that may be necessary to meet the requirements of host country law without applying to the institution requirements that are not provided for under the home country's standards. Under this approach, the host country supervisor's assessment would give substantial weight to whether the home country supervisor judges an institution's capital sufficient to support such activities.

A related question arises regarding the application of host country capital requirements to non-domestic banking institutions' locally-incorporated subsidiaries (for example, a locally-chartered bank subsidiary). Regarding this issue, we urge the Committee to clarify that in determining whether a locally-incorporated subsidiary meets applicable host country capital requirements (a matter that is of proper concern to the host country supervisor), a host country

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[1] In this regard, we urge the Committee to review the appropriateness of local capital (also called endowment or dotational capital) requirements for branches of non-domestic banking institutions in view of the existence of internationally agreed upon capital standards for such institutions as global entities.

supervisor should adopt a flexible approach that takes into account the interrelationships between the subsidiary and the global banking institution of which it is a part.

Responsibilities of Home Country Authorities under Pillar 3 (Market Discipline)

Similar concerns regarding the relationship between home and host country requirements that arise in connection with the supervisory review process also arise in connection with the reliance placed on disclosure as a means to encourage market discipline under Pillar 3. In this area, where the New Accord intends that market discipline be applied to a global banking institution as a whole, it is especially important that home country requirements be respected and that the home country authority exercise responsibility for supervisory review of an institution's disclosure. A contrary approach – one in which global banking institutions would be required to abide by different disclosure requirements applied by different host countries – would be extremely burdensome to institutions and would promote market confusion rather than market discipline. It is recognized, however, that an institution may become subject to disclosure requirements of a host country's securities regulator to the extent it elects to issue securities in the host country's market.

Operational Risk Matters

As there remains considerable work to be done with respect to both the analytical and quantitative understanding of operational risk for regulatory capital purposes, we urge the Committee to finalize the New Accord without formally adopting any operational risk capital charge. A final determination on how to treat operational risk should be delayed pending the accumulation of more extensive and reliable data regarding operational risk loss experience and the development of more robust methodologies for quantifying such risk. In the event the Committee at some point in the future decides to apply an explicit capital charge for operational risk, we urge that operational risk mitigation tools, particularly insurance, be given explicit recognition. In addition, we urge the inclusion of an adjustment factor that would benefit banking institutions possessing rigorous and robust operational risk programs.

ACHIEVING AN APPROPRIATE BALANCE BETWEEN HOME AND HOST COUNTRY SUPERVISORS

Applying the Four Key Principles under Pillar 2

We fully endorse the four key principles underlying the second pillar's supervisory review process, which recognize that ultimate responsibility for the adequacy of a banking institution's capital and its allocation in accordance with the institution's risk profile rests with the institution's management. At the same time, we recognize that supervisory review of the actions taken by an institution to implement the applicable requirements is fundamental to the integrity of the risk-based capital standards contemplated by the New Accord. Likewise, it is essential to establish procedures under the New Accord that will enable supervisors to ensure that each institution has sound internal processes in place to assess the adequacy of its capital and set targets for capital that are commensurate with the institution's specific risk profile and control environment.

Effective oversight of banking institutions that operate in different countries and whose risk profiles are critically influenced by complex interrelationships among an array of factors necessarily requires a unifying, comprehensive supervisory perspective. As the risk-based capital standards are intended to be applied to institutions on a consolidated basis, it is appropriate that responsibility for oversight of an institution's adherence to these standards vest with the authority that oversees the operations and financial soundness of the institution on a global basis: the home country supervisor.

This means in particular that a banking institution's home country supervisor, and not any of its host country supervisors, should be responsible for the following determinations regarding its capital:

- The adequacy of an institution's overall capital in relation to its risk profile.
- Supervisory assessment of an institution's internal methodologies for determining capital adequacy and allocating capital to its risks.
- Whether to require an institution to hold regulatory capital in excess of the minimum called for under the New Accord and, if so, what the appropriate level of regulatory capital should be.
- The establishment of the minimum ("trigger") capital ratio for an institution, which may be greater than the minimum called for under the New Accord, and the determination of an institution's "target" ratio, which would provide a warning that the institution is operating too close to its trigger ratio.
- Whether, and if so how, to intervene to prevent capital from falling below the required level.
- Action that must be taken by an institution to restore its capital in the event it falls below the minimum requirement.

In emphasizing the primary role of home country supervisors, we do not mean to suggest that host country supervisors should ignore the capital of non-domestic banking institutions or that they have no role in matters relating to capital. An institution's capital adequacy is fundamental to its financial strength and as such is a relevant consideration to a host country supervisor in connection with its oversight of the institution's operations in the host country. In addition, the host country supervisor's greater familiarity with conditions in its markets makes it a source of information and insight that can be valuable to a home country supervisor in its efforts to understand and assess the risks undertaken by institutions headquartered in the home country and the adequacy of such institutions' capital in the face of such risks. For these reasons, we strongly support efforts by the Committee to promote increased dialogue and exchange of information between home and host country authorities on matters relating to capital.

In the event a host country supervisor develops serious concerns regarding the fundamental safety and soundness of a non-domestic banking institution, it should work with the home country supervisor to resolve the situation. While the home country supervisor remains responsible for the institution's capital adequacy, the host country supervisor has at its disposal a wide array of options to address any problems the institution may have in the host country, including, in the most dire cases, the authority to terminate the institution's operations in the host country that are the source of its concerns.

The Importance of Host Country Deference to the Home Country

Concentrating supervisory responsibility in the hands of home country authorities ensures that oversight of capital matters rests with the supervisory agency that is in the best position to comprehend and assess a global banking institution's capital requirements and how they are affected by the conduct of its operations around the world. This approach will best support an institution in its efforts to evaluate its credit, market, interest rate and other types of risks on a global basis. Equally important, it provides an institution's management the necessary assurance that it will not be subject to duplicative or potentially conflicting requirements on a matter that is of such critical importance to the institution's safety and soundness, which would likely occur if one or more host countries also sought to provide supervision in the capital area.

Respecting the primary role of the home country supervisor is fundamental to the feasibility and effectiveness of the New Accord. Under the approach contemplated by our comments, host country supervisors should not seek to replicate determinations on capital made by home country supervisors or substitute their judgement on such matters for those of a home country supervisor. This is especially true with regard to a banking institution's reliance on either of the internal ratings-based (IRB) approaches to measuring credit risk. It would be extremely burdensome and contrary to the principle that the New Accord represents an internationally agreed upon supervisory framework if an institution were subject to the approval of a multiplicity of supervisory authorities outside its home country regarding the methods it selects to allocate capital for credit risk. Accordingly, the decision by the home country supervisor on the suitability of an institution's IRB systems should be determinative.

Host Country Treatment of Branches and Locally-Incorporated Subsidiaries of Non-Domestic Banking Institutions

Host country deference to determinations on capital by a banking institution's home country supervisor is especially appropriate where the institution operates in a host country through branches and does not control any locally-chartered depository institution subsidiary. As an integral part of the banking institution itself, the operations of a branch are supported by the capital of the institution as a whole, which is allocated by the bank's management in accordance with its global strategy. It is recognized that a host country authority in the proper exercise of its supervisory and examination powers over a branch of a non-domestic banking institution strives to understand and evaluate the institution's risk management processes and systems as they relate to the operations of the branch in the host country. However, assessing the capital adequacy of the institution and conducting a supervisory review of the institution's

management, systems and controls for allocating capital on the basis of its global risks should be matters uniquely within the supervisory oversight of the home country authority.

Additional considerations arise where a banking institution, whether or not it also chooses to operate in a host country through one or more branches, controls a locally-chartered depository institution subsidiary and/or other types of locally-chartered subsidiaries that themselves may be subject to separate capital requirements prescribed under host country law. In determining whether a locally-chartered subsidiary meets these requirements (a matter that is of proper concern to the host country supervisor), a host country supervisor should adopt a flexible approach that takes into account the interrelationships between the subsidiary and the global banking institution of which it is a part.

For example, the determination of whether a locally-chartered depository institution subsidiary of a non-domestic banking institution is eligible to use the IRB approach to credit risk should take into consideration whether the subsidiary has implemented elements of the systems and procedures utilized by the parent institution in connection with the risk management of its global operations, regardless of whether they are the same as those utilized by domestic institutions that are permitted to use the IRB approach. If the locally-chartered subsidiary has done so, and if the parent institution's systems and procedures have been approved and are reviewed by the institution's home country supervisor (and the home country supervisor oversees the operations of the institution on a consolidated basis in accordance with international standards), then the host country supervisor should accept the validity of the institution's systems and procedures as applied by the subsidiary and not require the subsidiary to implement the IRB approach in the same manner expected of domestic institutions.

As discussed above, we believe that as a general supervisory matter the determination of whether a banking institution's capital should be greater than the minimum required under the New Accord and, if so, what that greater amount should be is the sole responsibility of the home country supervisor. We recognize that circumstances may arise in which host country law (i) restricts the authority of banking institutions (whether domestic or non-domestic) to engage in certain activities in the host country to those that have capital ratios in excess of the minimum required under internationally agreed upon capital standards and (ii) directs the host country supervisor to make a determination on the adequacy of non-domestic institutions' capital for these purposes.[2] We believe that in these circumstances a host country supervisor should consult with the institution's home country supervisor and make its determination by utilizing home country standards (so long as such standards are consistent with international standards), taking into account any adjustments that may be necessary to meet the requirements of host country law without applying to the institution requirements that are not provided for under the home country's standards. Under this approach, the host country supervisor's assessment would give

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[2] A recent example of such a requirement is found in the provisions of the Gramm-Leach-Bliley Act which condition the authority of banking institutions to engage in expanded financial activities (such as securities underwriting, insurance underwriting and merchant banking) in the United States on whether an institution is and remains "well capitalized" – a standard that requires, among other things, that the institution's Tier 1 and total risk-based capital ratios at all times be at least 6% and 10%, respectively.

substantial weight to whether the home country supervisor judges an institution's capital sufficient to support such activities.

IMPLICATIONS FOR THE PROMOTION OF MARKET DISCIPLINE UNDER PILLAR 3

Concerns regarding the appropriate balance between home and host country supervision also arise under Pillar 3 of the New Accord. We agree that market discipline, supported by an appropriate public disclosure regime, can be an effective complement to supervisory efforts to encourage banking institutions to assess risk, maintain capital and develop and maintain sound risk management systems and practices.

Our concerns relate to the interconnections between Pillars 2 and 3 that are contemplated under the New Accord. The Consultative Document on Pillar 3 states that "it is envisaged that an important part of Pillar 2 will consist of a review of on-going compliance with the requirements to use particular capital treatments, including disclosures, and a more general review of disclosure by the institution" and that "supervisors should evaluate a bank's disclosure regime and take appropriate action."[3] We support disclosure as a means to encourage market discipline, but urge the Committee to clarify that, as is the case with other aspects of the New Accord, responsibility for the supervisory review contemplated under Pillar 3 rests with an institution's home country supervisor.

As a corollary to the primary role of the home country supervisor in reviewing a banking institution's disclosures under Pillar 3, we further urge clarification that the applicable disclosure requirements are those set by the home country. A contrary approach – one in which banking institutions would be required to abide by a variety of different disclosure requirements applied by different host countries – would be extremely burdensome to institutions and would promote market confusion rather than market discipline. It is recognized, however, that an institution may become subject to disclosure requirements of a host country's securities regulator to the extent it elects to issue securities in the host country's market.

OPERATIONAL RISK

Based on discussions and consultation with our member institutions, we are concerned that there is not a sufficient statistical and analytical basis at the present time to implement an explicit capital charge for operational risk. Accordingly, we urge the Committee to finalize the New Accord without formally adopting any operational risk capital charge. A final determination on how to treat operational risk should be delayed pending the accumulation of more extensive and reliable data regarding operational risk loss experience and the development of more robust methodologies for quantifying such risk.

In the event the Committee at some point in the future decides to apply an explicit capital charge for operational risk, we have three recommendations. First, we recommend that operational risk mitigation tools, particularly insurance, should be explicitly recognized in the

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3 Consultative Document, Pillar 3 (Market Discipline), p. 4.

calculation of the capital charge. Markets for such insurance are developing quickly, and supervisors should have the discretion to establish criteria for operational risk mitigation tools that qualify to offset capital charges. Indeed, the implementation of such criteria should itself facilitate the further development of active markets for operational risk insurance and other mitigation tools.

Second, we recommend that the calculation of any such charge include an adjustment factor that would benefit banking institutions that have rigorous and robust operational risk programs. Providing such an adjustment factor would encourage institutions to increase their efforts to identify, evaluate and manage operational risk in an effective manner. It also would further the Committee's intention that "increasing levels of sophistication of risk management and precision of measurement methodology should generally be rewarded with a reduction in the regulatory operational risk capital requirement" (quoting from page 2 of the Committee's "Operational Risk" Consultative Document).

Third, we recommend that any such capital charge be structured to preserve banking institutions' prerogatives to evaluate and incur various types of operational risks on a global basis (including, for example, in the distribution of business lines, where such risks might be higher in one location or another, although, on a global basis, such risks are appropriately identified, evaluated and contained). Primary responsibility for supervisory oversight of these risks would rest with the institution's home country supervisor. In the event a host country supervisor develops concerns regarding an institution's operational risks in the host country, it would consult with the home country supervisor on how best to resolve the situation. The application of host country operational risk capital requirements, even in form of "earmarking" or other informal requirements, should be discouraged in favor of active information sharing among home and host country supervisors regarding these risks.

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Please contact the Institute if we can provide any further assistance.

Very truly yours,

Lawrence R. Uhlick

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