SOUTHSIDE BANK

P.O. BOX 1079, SOUTH BECKHAM AT EAST LAKE, TYLER, TEXAS 75710-1079 903/531-7111 Fax: 903/592-3692

JERYL STORY
SENIOR
EXECUTIVE VICE-PRESIDENT

May 22, 2001

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

Secretariat:

Re: New Basel Capital Accord

This letter is in response to the Basel Committee proposal to amend the 1988 International Capital Adequacy framework dated January 2001.

Southside Bank was chartered in 1960 and is a state non-member bank. Southside Bank is owned 100% by a one-bank holding company, Southside Bancshares, Inc. At year-end, total assets were over $1 billion. Southside Bank is predominately a consumer and small business oriented bank, serving all of East Texas. The company makes all types of commercial and consumer loans to local industries and residents of Smith and seven surrounding counties. For regulatory purposes, the bank is classified, under present 1988 Accord standards, as "well capitalized". The bank has a brokerage and finance company subsidiary relationship as well as seven grocery store branches, three motor bank locations, five "stand-alone" branches and twenty-two, twenty-four-hour ATMs.

I have been in banking for over 25 years mainly in the area of loans and loan administration. I have been with Southside Bancshares, Inc. for over 21 years.

Major items of concern that we believe need to be addressed, include the following:

1. The new document is attempting to explain several complex issues and ideas for capital requirements. In doing so, there are numerous unanswered questions and incomplete processes throughout the proposal making it difficult to make sufficient remarks regarding our concerns.

2. We believe very strongly that it would be difficult to apply the complexity of the proposed changes to determine capital adequacy to every financial institution. Resources, expertise, data, and applicability would be difficult to implement at financial institutions that do not have international loan portfolios. In addition, large balance sheet institutions do not necessarily equate to a large or complex corporate and/or retail loan portfolio. We believe that if there is to be a cut-off as to the applicability of the proposed

capital adequacy standards, it needs to be based on not only asset size, but also the characteristics of the loan portfolio.

3. While we recognize that Pillar Two covers Supervisory Review, we have no evidence that the supervisory agencies have more expertise than the individual institutions themselves and yet all authority is theirs. The proposed capital Accord incorporates supervisory input in too many areas regardless of the approach the bank can elect or is required to implement. There is almost total dependence on supervisory inputs before a bank can get to the point of determining capital adequacy in any approach used. Before using an outside credit-assessing agency to "rate" a corporate debt, the supervisory authority must approve the agency. In the Foundation IRB approach, the LGD and EAD are determined by the bank's supervisory authority. If a bank uses the Advanced IRB approach, supervisory authority must approve the methods and processes for determining LGD and validate the outcome. When calculating the new Operational Risk amount under the Basic Indicator Calculation Method, the bank's supervisory authority determines the fixed percentage applied to gross income. We believe this would give the supervisory authority too much subjective input into a particular financial institution's capital plan. This is in such contrast to the 1988 Accord where set guidelines were established versus the new proposal where control appears to shift to the supervisory authorities. The supervisory authorities already have access to a bank's records through safety and soundness examinations that allows them to "overrule" or accept a rating established by the bank.

4. Implementing the new Accord will be an extremely expensive process especially in the area of record keeping. Due to the extent of the current business cycle, records will have to go back for 10 years to have any relevance. Since we have been experiencing many years of good times, it will take going back at least 10 years to acquire and compare information during the down cycles. Also, the makeup of world economics is significantly different today than it was 10 years ago.

5. The new capital Accord is so complex and detailed that a bank will be required to hire outside resources and/or purchase software programs just to implement even the most basic approach. We are not embarrassed to admit that no matter what information has been supplied with the proposal, we did not fully comprehend nor understand every aspect of all the inputs required. This complexity opens the door for error, not only because of the great quantity of data required, but the application of specific methods to determine specific values. We are concerned that this complexity will force most banks to spend resources on misguided products because of the perceived and real calculations necessary to determine required values. In our opinion, we believe that this complexity is demonstrated with regard to your explanation of the calculation of risk weights and the interrelationship between PD percentages and BRW values. The graph is supposedly showing the relationship between BRW values and PD percentages, but the graph identifies BRW values as risk weight percentages (i.e., page 73 of the Consultative Document for The New Basel Capital Accord).

6. We have difficulty understanding why a financial institution with similar characteristics as ours could have the possibility of being required to maintain a capital adequacy level of more than 8%. Under the current Accord, it is difficult enough to produce the market requirements for return on equity while meeting the minimum 8% capital requirements. If capital requirements were to increase, it will be harder for the smaller institutions to attract the additional capital.

   Operational risk is difficult to measure in specific dollar amounts when it can drastically fluctuate from year to year. Gathering data on historical fraud events or restitution events would be difficult, if not impossible, to obtain. We believe that it is grossly unfair to require a bank to allocate capital for operational risk when it is currently being accounted for as the event occurs. We also believe that our reserve accounts are high enough to cover loan losses and operational risks without an additional measure. However, as an additional measure, we carry adequate insurance coverage. Can operational risk be mitigated by this insurance coverage and like programs? An increase in reserves for operational risk can send a misleading message to an investor regarding the activities and soundness of the bank's financial position. Even an average of prior years' dollar amounts cannot fairly represent three good years should there be one bad year in the average. In the suggested Basic Indicator calculation, we are unable to see how applying a fixed percentage to gross income will accurately represent any measure of operational risk. The internal measurement calculation is complicated and very subjective requiring too many supervisory inputs and would be difficult for most financial institutions to implement.

8. In addition to operational risk being an extremely subjective figure, the ramifications of having additional capital required as defined in the proposal for operational risk could potentially have a deleterious effect on some financial institutions. Capital adequacy has long been the pillar for supervisory action and closure in banking. The Basel Accords equate capital adequacy to perceived risk rather than actual losses. Will the capital measures and capital category definitions under Part 325 regulation of the FDIC Rules and Regulations be redefined to account for each bank's individual calculated capital requirements? What will be the effects of this added operational risk to these guidelines?

Again, the proposed Capital Accord is an extensive document with many areas of concern left incomplete, which does not allow for sufficient comments. However, we have addressed our major concerns. We appreciate the opportunity to comment on the proposed Capital Accord and anticipate that our comments will provide meaningful input to the discussion of the finalized Accord.

Sincerely,

Jeryl Story
Senior Executive Vice President