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To: Basel Committee on Banking Supervision

"The New Basel Capital Accord" ("proposal") is the second consultative package published by
the Basel Committee ("Committee") in response to the increased need for regulatory capital
reform. The new framework puts more emphasis on a bank's own internal methodologies,
supervisory review, and market discipline. It is designed to be more flexible and more risk
sensitive. The structure of the proposal is based on three pillars: minimum capital requirement,
supervisory review process, and market discipline. The three mutually reinforcing pillars are
expected to contribute to the safety and soundness in the financial institution.

The Banking Supervision and Regulation Department of the Federal Reserve Bank of Richmond
reviewed the "The New Basel Capital Accord." We acknowledge the weaknesses in the 1988
Capital Accord and recognize the revision will provide numerous improvements to the program.
As noted in our March 2000 response, we are in general agreement with the proposal, including
the following changes:

- Elimination of the OECD preferential treatment;
- Introduction of 150% risk weight category;
- Elimination of 365 day benchmark for commitments;
- Elimination of capital arbitrage opportunities created through securitizing assets;
- Introduction of the three pillar program;
- Acknowledgement and incorporation of influence of industry analysts and investors in
  maintaining satisfactory capital levels (i.e. use of external ratings and market
disclosure);
- Introduction of operational risk capital charge; and
- Use of financial institutions internal measures of credit risk;
Although we are in general support of the proposal, as regulators we have concerns that we want to bring to the Committee's attention. We are especially interested in ensuring that the financial institutions have incentives to accurately assess risk and allocate appropriate capital. The proposal should not allow banks the opportunity to benefit from under-reporting risks, including credit deterioration and operational losses. Listed below are several areas that may require additional attention from the Committee.

**Complexity and Applicability**

The size and complexity of the proposal may preclude less sophisticated financial institutions from fully understanding the implications of the new guidelines. Some of the nuances of the new rules may be lost on even the larger organizations. We are concerned about the level of industry awareness, especially from our regional institutions. Further, it is unclear which U.S. banks will be required to implement the new guidelines. While we recognize that each country must decide the full extent of the applicability of the framework, requesting industry comment before that has been decided leaves the regional companies at a disadvantage if they do not understand the impact to their organization.

**Consumer Lending**

The proposal recommends that a capital charge be implemented for unused lines for credit cards. As these assets have a high probability of default, this capital charge will be higher. We recommend that some consideration be given to these institutions with higher reserve levels and strong earnings that serve as mitigating factors for the level of risk associated with these assets. The Committee should be cautious to ensure that consumer lending does not become cost prohibitive and therefore affect credit availability.

**Securitizations and Implicit Recourse**

The proposal calls for an add-on charge for outstanding notional trust balances. While we believe that implicit recourse should be addressed, we ask the Committee to consider whether the revolving master trust structures may be unfairly penalized under the new rules due to the early amortization provisions. Securitizations are priced in the market based on a perception of the managed company's ability to generate strong performing assets on an ongoing basis in excess of early amortization floors. Our focus as regulators should be more on the institution's funding mix and the availability of funding under stress rather than the need to hold more capital.

**Operational Risk**

The Basle Accord proposes three methods for calculating operational risks: a basic indicator approach that utilizes a single value for the bank's overall operation; a standardized approach, where the bank is divided into business lines with each getting a separate indicator; and an internal measurement approach, allowing more sophisticated banks to use their own internal...
data. We are concerned about the lack of data on operational risk, and acknowledge that banks have been very reluctant to publicize details of losses from such problems as deficiencies in internal controls, human error, or system failure. We agree that operational risk needs to be addressed and it is a difficult risk to quantify and can be very subjective. However, the significant gaps in the current proposal makes it difficult for the industry to fully evaluate and comment on the implications of the capital charge. Again we are concerned with the incentive to underreport problems or mask deficiencies to avoid the public disclosures and the capital charge.

Internal Capital Allocation Models

In our experience, large and regional financial institutions have invested in internal capital allocation models and made progress in the adoption of these models in order to improve profitability and make business decisions based on hurdle rates. The banks may have a conflict of interest as they use the same model to optimize profitability and to determine adequate capital levels. These two goals can be contradictory as they try to maximize their return on equity. In order to validate the capital allocation methodology, supervisors will need a thorough understanding of economic capital models and be able to verify that risk is not understated in an effort to maximize that return.

In addition, institutions will be challenged in the incorporation of the operational risk into their economic capital allocation models. Again the incentive exists to understate the risk in order to improve the shareholder return.

Market Disclosures

The bankers are understandably concerned about the confidentiality issues related to market disclosures and whether the playing field will be level across all countries. Furthermore, the frequency and method of disclosures has not been decided. This leads to questions about how improvements and, more importantly for regulators, deterioration of credits will be recognized by the market if disclosures are as infrequent as annual. A particular institution may continue to be treated as low risk by the market when in reality the credit risk has significantly increased since the most recent public disclosure. As regulators, we believe at least semi-annual disclosures must be required. Additionally, these disclosures would have to monitored to ensure compliance and consistency among institutions, which will place further demands on examiner resources.

Bank Resources

The cost of implementing the new guidelines is unknown at this point, but is expected to be considerable in some cases. In order to conform to the minimum requirements, some banks will have to make some significant investments in computer system upgrades, additional manpower, improvement of risk management practices, and the capture and development of data. During this period of implementation, banks will simultaneously be trying to maintain earnings and conduct business as usual. We have some concerns about the cost / benefit of implementing these changes for some of the less sophisticated banks.
Implementation Consistency

It is unclear how supervisors will ensure consistent implementation within and between countries. As global banking becomes more important to the large financial institutions, it is imperative that all banks are on a level playing field. As regulators, we are interested in ensuring that all banks operating in the U.S. compete on an equal basis.

Rating Agencies

As noted in our previous response submitted to the Committee, we appreciate the independent review that will be afforded by the external rating agencies. However, the following concerns remain:

- Incentive for companies that would be rated low (below B-) to avoid the rating process.
- Ratings as lagging indicators – downgrades may come too late to take effective action.
- Maintenance of independence of agencies.
- Regulation / supervision of agencies.
- Amount of influence of agencies on financial industry capital levels.

Internal Rating Methodologies

Although using internal ratings will allow for greater accuracy of risk weightings and capital allocation, several concerns remain with this method including the following:

- Lack of consistency among institutions/countries
- Incentive to understate risk.
- Ramifications if untested during times of increasing problem credits.
- Requirement of subjectivity and business judgement.
- Challenge to regulators to assess the suitability of each bank’s system.

Recommendations:

- Clarify which U.S. financial institutions will be required to comply with the new guidelines.
- Allow for comment period before the proposal is finalized.
- Follow up with national supervisors to ensure sharing of information and consistency between countries.
- Establish international best practices or procedures for supervisors that would be transparent to financial institutions.
- Implement a world-wide confidential database for operational loss events.
- Incorporate all outstanding proposals related to capital, including asset securitization residuals, merchant banking, subprime lending, and the simplified capital framework for noncomplex institutions.

Conclusions:

Although we raised several concerns for which we do not have a solution, by increasing awareness of issues and working together with other countries, we are more likely to establish a strong foundation for capital calculation. We expect that the U.S. regulators, along with their
international counterparts, will build on the new framework and work towards a more effective, risk sensitive capital allocation methodology.

Sincerely,

[Signature]

Malcolm C. Affriend
Vice President