July 31, 2003

Basel 2003 Capital Proposal
Board of Governors
of the Federal Reserve System
Mail Stop 155
20th Street and Constitution Avenue, NW
Washington, DC 20551
Regs.comments@federalreserve.gov

Secretariat
Basel Committee on Banking Supervision
Bank for International Settlements
CH - 4002, Basel
Switzerland
BCBS.Capital@bis.org

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

Basel 2003 Capital Proposal
Office of the Comptroller
of the Currency
Mail Stop 3-6
250 E Street, SW
Washington, DC 20219
Basel.Comments@occ.treas.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
regs.comments@ots.treas.gov

Re: The New Basel Capital Accord

Dear Mesdames and Sirs:

America's Community Bankers (ACB)[1] is pleased to comment on the third Consultative Document of the proposed New Basel Capital Accord (Accord) released for comment in April

[1] ACB represents the nation's community banks. ACB members, whose aggregate assets total more than $1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

2003 by the Basel Committee on Banking Supervision at the Bank for International Settlements (BCBS). Our comments also are being sent to the four primary U.S. banking supervisors: the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (OTS).

The Accord is intended to replace the current version of the Capital Accord issued in 1988 that establishes risk-based capital requirements for depository institutions. The Accord will consist of three mutually supportive pillars: minimum capital requirements under Pillar I, supervisory review of capital adequacy under Pillar II, and public disclosure of risk profile and regulatory capital information under Pillar III.

ACB Position Summary

ACB agrees with the approach of the proposed Accord in trying to more clearly link minimum capital requirements with an institution's risk profile and commends the efforts of BCBS members who have spent considerable time in developing the current proposal. It is clear that BCBS members have taken into account comments on previous versions of the Accord and have revised the document to be responsive to those comments.

As an initial matter, ACB believes strongly that the OTS should be given a formal role as a member on the BCBS. The OTS, which is the primary federal regulator in the United States for approximately 1,000 financial banking institutions and over $1 trillion in assets, regulates many of ACB's members. The OTS also regulates diversified holding companies with foreign operations or foreign parent companies.

The objectives of any capital accord should be to promote stability by requiring that sufficient capital be available, ensure competitive equality, and enable interested parties such as banking supervisors, bank management, and investors to effectively monitor capital levels and intervene when necessary. ACB does not believe that the Accord yet meets these goals and continues to have serious concerns about the cost and complexity of the Accord, the ability of institutions to understand and implement Pillar I and of supervisors to adequately administer and enforce the minimum capital requirements, and the potential of the Accord to create competitive inequities.

ACB also continues to oppose a uniform capital charge for operational risk in Pillar I and believes that any additional capital needed to account for this type of risk should be determined under the supervisory review process in Pillar II.

While ACB supports greater disclosure of information so that investors and others can understand the risk profile of a financial institution, the BCBS should ensure that the disclosure requirements address the types of information that members of the public that are not well versed in all of the technical details of the Accord will understand and find useful. The information requirements should continue to be evaluated and refined so that they require disclosure of useful information without being unduly burdensome, and that they are consistent with accounting principles and securities laws in the United States and other countries.

The OTS should be a Formal Member of the BCBS

The United States has four primary federal bank supervisors. The OTS, the regulator of the majority of our members, supervises savings banks and associations and their holding companies. The OTS is a bureau of the U.S. Department of the Treasury. The OTS plays a vital role in the supervision of U.S. financial institutions by supervising 1,000 financial institutions and over $1 trillion in financial assets. While some of these institutions are small, community-based savings associations, the OTS also supervises multi-billion dollar institutions and their holding companies.

U.S. savings associations are primarily in the business of making mortgages and other consumer loans. While not usually active internationally, the Accord will affect these institutions in both direct and non-direct ways. Therefore, it is essential that the primary supervisor of these institutions, the OTS, have a formal role, rather than merely an observer role, at the BCBS. This will ensure that all types of U.S. banking organizations are represented at the BCBS and will allow for a more orderly implementation of the final Accord in the United States.

The OTS is one of the preeminent regulators of residential mortgage lenders in the United States and no other U.S. representative has comparable expertise in regulating depository institutions that specialize in residential mortgage loans. The OTS also is particularly skilled at assessing interest rate risk, and this experience, together with the OTS's experience and perspective in regulating diverse holding company structures, would be an important addition to the BCBS.

Competitive Impact

The results of the BCBS's Quantitative Impact Study 3, although based on incomplete information, indicate that institutions that can use the internal-ratings based (IRB) approach to determining capital and that have primarily a retail portfolio may see their minimum capital requirements reduced significantly. Retail lending, particularly residential mortgage lending, is the fundamental business of ACB's community bank members. As a result, we are concerned that smaller institutions that do not possess the resources necessary to develop an IRB system for assessing capital, or do not have business models that would make the costs associated with such a system reasonable in relation to expected benefits, will be left at a competitive disadvantage. Many community banks will end up holding higher capital under the Accord as compared with global and potentially more risky institutions.

Smaller institutions will be at a competitive disadvantage to the extent that they cannot deploy capital as efficiently as larger, more sophisticated institutions. Capital is a fundamental financial metric that all companies actively measure, manage and massage in order to improve earnings and competitive position. There are few, if any, transactions in which a bank does not consider the impact on capital. Smaller institutions likely will become takeover targets for institutions that can establish an IRB approach to capital and the small banks that survive as stand-alone entities will find it more difficult to compete for quality assets, leaving them with riskier assets, lower credit ratings and higher costs of liabilities.

Competitive inequities caused by the differences in the credit risk charge are exacerbated by the differences in the operational risk charges that will be assessed under the different approaches to measuring operational risk, described below in more detail. Larger, more sophisticated institutions will have more flexibility in determining the operational risk charge and will be able to take into account to a certain degree the mitigating effects of insurance. These options will not be available to the smaller institutions that do not have the resources to establish sophisticated operational risk management systems or the business structure and operations that would require such elaborate systems. These institutions will be subject to a fixed charge based on gross income, which could result in a higher operational risk charge for institutions that, in fact, have lower operational risk than institutions with more complex and sophisticated operations.

Finally, competitive implications can result from the different ways in which the Accord is implemented in different countries. Although the level of detail in the third Consultative Paper has been reduced from prior versions, more decisions about implementation have been left to bank supervisors. Bank supervision varies significantly from one country to another in approach, intrusiveness, and quality. The manner in which the Accord is implemented and enforced against institutions in one country can provide a competitive advantage or disadvantage to organizations in another country that might face more lenient or more strict application of the Accord's provisions. Particularly with regard to the supervisory review process under Pillar II, implementation and enforcement from country to country may be significantly different.

ACB does not believe that the Accord should become effective until the competitive implications are further reviewed and understood. We would recommend that the BCBS conduct another quantitative impact study using more complete and reliable information from a greater number of banking institutions to further understand these implications. Also, the BCBS should continue to review the issue of disparity in supervision of the Accord. The formation of the Accord Implementation Group is a step in the right direction, but further efforts need to be made to ensure that the Accord will be implemented in an even-handed way across borders.

Implementation Issues

Although the most recent version of the Accord is less detailed than previous versions, it remains an extremely complex document and few industry representatives and supervisory personnel will have a good grasp of all of the provisions and intricate details. With that being the case, there is concern about how such a sophisticated and complex capital accord can be adequately implemented, supervised and enforced. Since adequate capital is so important to the global financial community, the inability to properly assess and measure compliance with capital requirements can lead to significant safety and soundness issues.

Implementation concerns initially lie at the financial institution level. Institutions will have to hire and retain the necessary expertise to implement the Accord throughout the organization.

These experts will have to explain to the institution's management in an understandable way the models used by the institution, how those models comply with the requirements of the Accord, and the impact on the institution from changes in the model. The public markets recently have been harmed by companies that employed sophisticated and opaque financial instruments and accounting principles that could not be understood by a company's board, management or investors. The Accord could lead to similar obfuscation since relatively few people at an institution will completely understand all of its technical details and the models used by the institution.

It is unclear how an institution can be properly managed by people who will not understand how adequate levels of capital for the institution are determined and the types of risks posed by models that may not be adequate for the institution's operations. Experts have estimated that it could cost up to $200 million for large, internationally active banks to establish the necessary infrastructure to comply with the advanced IRB approach to credit risk. Significant sums also will be needed to comply with the IRB foundation approach. The banks that can devote these resources will face tremendous challenges in managing the implementation of such a complicated scheme. It is unlikely that any director or officer will have more than a surface understanding of the Accord or the bank's own IRB model. Only a handful of employees at any institution will understand the most complicated elements of the models and virtually no one will understand it in totality. The individuals that can understand the complexity of the models will probably not fully understand the dynamics of each business unit and could easily miss important, subtle distinctions or developments that could have a dramatic impact on real-world risk at the bank.

The other major implementation concern is at the supervisory level. It is questionable whether regulators can administer overly complex and sophisticated capital rules. All supervisory organizations will have to expend substantial resources to ensure that they have the necessary expertise and systems to administer and enforce the Accord. To the extent that funds are not available to do so, or the necessary expertise is not available, the Accord will not be administered properly, creating significant safety and soundness concerns. Even if supervisors can administer the complex rules, the effort to do so adequately could divert resources from other areas of emerging risks that should receive more attention.

In light of these concerns, more examination needs to be made into the real-world consequences of adopting an extremely complicated capital regime, including the resources needed for implementation, the problems inherent in on-going maintenance, the improbability of effective regulation and market oversight, and the competitive pressures that will encourage banks to game the system. Also, alternative approaches that do not represent such a radical departure from the existing regulatory capital framework should be considered. While there may be problems with the current capital requirements, it seems that those problems could be resolved in a way that is easier to implement and less costly to the industry. Revising the current accord to make it more risk-sensitive for all institutions and then adding more complexity to capture the additional risk at internationally active banks may be a better approach to measure and account for credit risk.

Pillars II and III then can be used by supervisors and the market to apply additional capital requirements when they are called for by the structure and/or operations of an institution.

Operational Risk Charges

ACB continues to oppose a separate operational risk charge under Pillar I. Although the Advanced Measurement Approach has been refined to accord financial institutions more flexibility in determining the charge, the Basic Indicator Approach and Standardised Approach, which are likely to be used by most institutions initially in light of the lack of available data and other implementation issues, remain linked to a fixed percentage of gross income. It is inappropriate to impose a regulatory capital charge against a risk that cannot be measured or even defined in a manner acceptable to everyone. Also, it is uniformly agreed that there currently is not sufficient empirical data to measure past operational losses and the establishment of systems to capture and analyze such data is still in the formative stages.

Operational risk is an area where internationally active banks take considerably more risk than do domestic, community-based organizations. These latter institutions are less likely to engage in large-scale fee generating activities, including payment and transfer or corporate trust, which create the largest exposure to operational risk. Applying a charge based on gross income puts all banks into the same category regardless of how the banks derive their income, the volatility of that income, or the level of exposure to various operational risks. In addition, there is no correlation between income and risk. Institutions that have trouble making money may also expend fewer resources on risk management and, therefore, may be more risky than institutions that have high levels of gross income, but expend the resources necessary to ensure that operational risks are identified, measured, monitored and controlled.

The Standardised Approach attempts to address some of the flaws in the Basic Indicator Approach by attributing operational risk capital to lines of business, but concerns remain because of the artificially high beta factors that must be used. These beta factors seem appropriate only for institutions that have above average exposure to operational risk in general.

The most recent version of the Accord establishes an Advanced Measurement Approach that provides for more flexibility in the development of bank measurement and management systems and eliminates a separate floor capital requirement. However, this approach will be available only to the institutions that have the resources to develop sophisticated, systematic approaches to measuring and managing operational risks and losses. This will create further differences in minimum capital requirements between larger, internationally active banks and small community banks, especially when you consider that the mitigating effects of insurance are not recognized under the Basic Indicator Approach or Standardised Approach.

In light of this, we think the better approach is to include operational risk in Pillar II and give supervisors the ability to determine the appropriate level of capital for each institution. Supervisory pressure can still act as a strong incentive for banks to continue to develop approaches to operational risk management and to ensure that banks are holding sufficient capital buffers for this risk.

Disclosure Requirements

ACB appreciates that the BCBS has scaled back the disclosure requirements, particularly those relating to the IRB approaches and securitisation, and has coordinated its approach with accounting authorities. ACB believes that further refinements should be made to the required disclosures to ensure that the requirements provide information useful and understandable to members of the public who will not know the technical details of the Accord. Disclosure of large quantities of information is not the same thing as transparency. As Federal Reserve Board Chairman Alan Greenspan has pointed out, "Transparency challenges market participants not only to provide information, but also to place that information in a context that makes it meaningful."[2] ACB further believes that some mechanism for revising the disclosure requirements should be in place to accommodate future advances in and changes to international and domestic accounting principles and securities rules and regulations.

ACB appreciates the opportunity to comment on this important matter. If you have any questions, please contact the undersigned at (202) 857-3121 or via e-mail at cbahin@acbankers.org, or Diane Koonjy at (202) 857-3144 or via e-mail at dkoonjy@acbankers.org.

Sincerely,

Charlotte M. Bahin

Charlotte M. Bahin
Senior Vice President, Regulatory Affairs

[2] Remarks by Federal Reserve Board Chairman Alan Greenspan on Corporate Governance at the 2003 Conference on Bank Structure and Competition at the Federal Reserve Bank of Chicago, May 8, 2003.