

INSTITUTE OF INTERNATIONAL BANKERS

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July 31, 2003

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

Re: Third Consultative Paper Regarding The New Basel Capital Accord

Ladies and Gentlemen:

The Institute of International Bankers is an association that represents the interests of financial institutions headquartered outside the United States that conduct banking, securities and/or insurance activities in the United States. The Institute is pleased to submit this comment to the Basel Committee on Banking Supervision (the "Committee") regarding the proposed New Basel Capital Accord ("Basel II") described in the Committee's third Consultative Document ("CP3").

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. Most of our comments regarding Basel II relate to an issue that we believe has not been sufficiently addressed in the Committee's publications concerning Basel II: the need for clear international standards for cross-border implementation of Basel II to ensure the primacy of the home country supervisor's role in supervising the capital adequacy of internationally active banking institutions under Basel II.

In our May 31, 2001 comment letter regarding the Committee's second consultative package, we identified several areas in which clarification of the respective roles of home and host country supervisors in supervising capital adequacy would be useful. Our members continue to believe that clarification of these issues remains vital to the successful international implementation of Basel II, and that the Committee is uniquely situated to address these issues.

The Institute's mission is to help resolve the many special legislative, regulatory and tax issues confronting **internationally headquartered** financial institutions that engage in banking, securities and/or insurance activities in the United States.

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Part I of this letter discusses issues relating to cross-border implementation of Basel II and makes several suggestions regarding areas that the Institute believes should be clarified in future Committee publications regarding Basel II. Part II of this letter makes a number of observations regarding two aspects of Basel II that we believe should be further improved—Pillar 3 disclosure requirements and the Committee’s proposed implementation schedule.¹

I. Cross-Border Implementation of Basel II

A. Introduction

One of the core principles underlying the original Basel Capital Accord (“Basel I”) and informing the development of Basel II is the importance of harmonized capital adequacy standards for internationally active banking institutions. In addition, beyond the context of risk-based capital requirements, the Committee has articulated international standards relating to the supervision of cross-border establishments of banking institutions, including in the Basel Concordat and the Core Principles for Effective Banking Supervision (the “Core Principles”). These international standards assign primary responsibility for supervision of a banking organization’s safety and soundness to the relevant home country supervisor.

In furtherance of the objectives of Basel II and the Committee’s international standards for cross-border bank supervision, we urge the Committee to articulate in the final Basel II documentation clear standards for the cross-border implementation of Basel II—not only for banks that operate branches in multiple countries but also for banks that operate locally incorporated bank subsidiaries in multiple countries. We commend the Committee’s formation of the Basel Accord Implementation Group (the “AIG”), which is considering cross-border implementation issues. At the same time, however, we believe that the publication of clear standards in this area is crucial. We would also encourage the Committee to consider establishing procedures for home-host country coordination regarding capital adequacy supervision, whether through the AIG or another forum.

In the Institute’s view, the complexity of Basel II’s advanced approaches to credit and operational risk, combined with Basel II’s reliance on supervisory discretion (both to approve a bank’s implementation of those approaches and to supervise capital adequacy more generally under Pillar 2), underscores the need for international standards and procedures for cross-border coordination. The more complex and discretionary the Basel capital framework becomes, the more likely supervisors are to reach differing good faith judgments regarding a particular bank’s implementation of the framework. This potential is illustrated clearly by the experience of many internationally active banks which use value-at-risk methodologies to calculate a market risk capital charge. It is not uncommon for home and host country supervisors to reach reasonable but conflicting determinations regarding the adequacy of a bank’s market risk models, back-testing results, etc. At times, these differences have been mitigated through coordination between regulators on the bilateral basis. However, given the materiality and scope of the Basel

¹ This letter does not attempt to address on a comprehensive basis all of the issues of concern to the Institute’s international bank members, as those issues are the subject of detailed and specific comments being submitted by our individual member institutions.

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II reforms, we believe more structured guidance is required to minimize the instances of conflicting demands by home and host country supervisors. In the absence of international standards and procedures for coordination, internationally active banks potentially face the impossible task of satisfying many different bank supervisors regarding the adequacy of their implementation of Basel II capital standards.

In addition, as Basel II is finalized, banking supervisors around the world will undertake to implement the Basel II framework through more detailed rules that necessarily will be adapted (i) to their financial markets, (ii) to applicable legal and regulatory requirements and (iii) to their banking institutions. It is thus inevitable that each country's implementation of the Basel II framework will entail some degree of variation. Some countries such as the United States propose to implement Basel II only for their largest internationally active institutions. Others may make specific modifications to one or more of the Basel II approaches to accommodate characteristics of their institutions or markets. Indeed, international variation of capital adequacy standards exists today under the considerably simpler Basel I framework, and the potential for such variation under Basel II is magnified significantly by the complexity of Basel II and its reliance on supervisory discretion.

B. Achieving an Appropriate Balance Between Home and Host Country Roles in the Supervision of an Internationally Active Bank's Capital Adequacy

Consistent with the Basel Concordat and the Core Principles, we urge the Committee to clarify that a banking institution's home country supervisor has primary responsibility for oversight of matters relating to the institution's capital adequacy under Basel II standards, so long as the home country supervisor oversees the operations of the institution on a consolidated basis in accordance with international standards established by the Committee.

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 the institution's capital adequacy:

- The adequacy of an institution's overall capital in relation to its risk profile.
- Supervisory assessment of an institution's internal methodologies for calculating credit, market and operational risk and allocating capital to its risks, including approval of an institution's use of advanced methodologies under Basel II.
- Whether to require an institution to hold regulatory capital in excess of the minimum called for under Basel II and, if so, what the appropriate level of regulatory capital should be.
- The establishment of any minimum "trigger" ratios for supervisory action against an institution, which may be greater than the minimum called for under Basel II, and the determination of any "target" ratios that would be used to provide a warning that the institution is operating too close to its trigger ratio.

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- Whether, and if so how, to intervene to prevent capital from falling below required levels.
- 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 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, consideration of applications to expand, etc. 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.

C. 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 Basel II. Under the approach contemplated by our comments, host country supervisors should not seek to replicate determinations on capital adequacy made by home country supervisors or substitute their judgment 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 and the advanced measurement approach ("AMA") to measuring operational risk. It would be extremely burdensome (and contrary to the principle that Basel II represents an internationally agreed upon

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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 and operational risk. Accordingly, the decision by the home country supervisor on the suitability of an institution's systems generally should be determinative.

Recognizing the potential that some countries may implement the advanced approaches to credit and operational risk in a manner that does not meet Basel II standards, the question that arises is how the foregoing principles of host country deference should be applied in practice. As noted above, the basic suggestion that we would urge the Committee to consider is the publication of clear standards for host country deference to home country determinations under Basel II. Internationally agreed upon standards on this subject will add an important element of transparency to the process of cross-border implementation of Basel II, transparency that is consistent with the overall objectives of the Basel II framework.

In addition, we would encourage the Committee to consider procedural mechanisms for resolving disagreements among supervisors regarding a bank's implementation of Basel II standards. For example, to the extent that a host country supervisor may seek to question the validity of an international bank's adoption of one of the advanced approaches under Basel II, or the integrity of the home country's approval process, such differences should be resolved between or among supervisors. There are any number of structures that could be used to achieve these objectives. The Basel Committee itself could assess national implementation of the Basel II framework, much as the Financial Action Task Force assesses national anti-money laundering efforts. Alternatively, the AIG could address specific differences on a case-by-case basis, applying what we would suggest be clear and public international standards requiring general deference to the judgments of home country supervisors.

Regardless of the particular structure that is developed, the overarching policy objective would be to avoid requiring international banks themselves to negotiate with each of their host country supervisors regarding the adequacy of their implementation of Basel II capital standards. In the absence of clear standards requiring general deference to determinations by the home country supervisor, and a mechanism for coordinating among home and host country supervisors (including some structure for addressing differences in judgments among the supervisors), the already significant burdens associated with implementing the Basel II framework will be unnecessarily compounded.

D. 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

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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 one of the advanced approaches under Basel II 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 advanced approaches. 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 generally 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.

Similarly, questions will arise in jurisdictions that limit their implementation of Basel II to the advanced IRB approach to credit risk and the AMA approach to operational risk (e.g., the United States, where between 10 and 20 banks are expected to adopt these approaches, while the remaining banks continue to use Basel I standards). For these jurisdictions, questions will arise regarding supervision of domestic bank subsidiaries of international banks that use the less sophisticated Basel II approaches on a consolidated basis.² Consistent with the principles outlined in this letter, host country supervisors in that position should permit the domestic institution to use the less sophisticated Basel II approaches, without requiring that the domestic institution to undertake the additional burdens to comply with host country Basel I standards. We believe it would be inconsistent with the role of Basel II as an internationally agreed upon framework if host countries were to refuse to recognize the use of Basel II approaches by locally incorporated bank subsidiaries of international banks that use those approaches on a global basis.

² See, e.g., Federal Reserve Board, Advance Notice of Proposed Rulemaking, July 11, 2003, at 26 (noting that U.S. subsidiaries of international banks would have the option of opting in to Basel II advanced approaches or remaining on Basel I, and inquiring regarding "the extent to which alternative approaches to regulatory capital are implemented across national boundaries might create burdensome implementation for the U.S. subsidiaries of [international] banks.").

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E. The Role of Host Country Supervisors in Assessing Compliance with Capital Adequacy Standards in Excess of Home Country Minimum Requirements

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 Basel II and, if so, what that greater amount should be is the primary 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 regarding 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.

U.S. capital standards under the Gramm-Leach-Bliley Act ("GLBA") illustrate the need for coordination in this regard and deference to home country supervisory judgments. Under the GLBA, an international bank with U.S. banking operations must be "well-capitalized" in order to engage in expanded financial activities in the United States (such as securities underwriting, insurance underwriting and merchant banking). Under applicable regulations implementing the GLBA, international banks from countries that have adopted Basel I capital standards generally must have Tier 1 and total risk-based capital ratios of at least 6% and 10% and must have capital that is "comparable" to the capital required for a U.S. banking organization under the GLBA.³

In response to questions regarding how the Federal Reserve Board will review international banks' capital adequacy under GLBA standards (including to make the required determination of "comparability"), Vice Chairman Ferguson of the Federal Reserve Board indicated that the Federal Reserve Board would accept whichever of the Basel II approaches an international bank adopts under home country standards for this purpose.⁴ The Institute strongly supports the approach articulated by Vice Chairman Ferguson. Nevertheless, there are lingering concerns among many international banks that host country supervisors will seek to

³ In applying this comparability standard, the Federal Reserve Board has taken into account international banks' leverage ratios (Tier 1 capital to total assets). This practice has been controversial among international banks, as there is no leverage ratio component in the Basel I framework (or, for that matter, in the well-capitalized standard for international banks set forth in applicable Federal Reserve Board regulations under the GLBA).

⁴ See Roger W. Ferguson, Jr., "Basel II: Scope of Application in the United States," before the Institute of International Bankers, New York, New York (June 10, 2003).

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independently review and evaluate an international bank's qualifications for the advanced approaches under Basel II, including the integrity of the home country approval process, home country Pillar 2 standards and home country Pillar 3 requirements and practices.

In the Institute's view, host country standards requiring capital in excess of Basel II minimum requirements present an especially compelling case for the development of clear standards and procedures to promote cross-border coordination and deference to home country supervisors. Experience in the United States suggests that the application of host country standards requiring higher capital ratios are more likely to prompt host country supervisors to independently evaluate a home country supervisor's judgment regarding the capital adequacy of an international bank. Higher capital ratios are often linked to advantages that are viewed as privileges and not entitlements—e.g., in the United States, expansion of non-banking activities, expedited procedures for obtaining regulatory approvals, etc.—making host country supervisors more likely to seek to exercise independent judgments regarding the international bank's qualifications to benefit from those privileges. However, international competition among global banking institutions makes the qualification for such privileges no less important than the more fundamental ability to operate cross-border establishments in a particular host country.

Consequently, the Institute would urge the Committee to include, as part of a statement of principles regarding cross-border implementation of Basel II, standards and procedures to promote host country deference to home country supervisory judgments in the context of capital standards in excess of Basel II minimum requirements.

F. Allocation of Operational Risk Capital

Another area of Basel II that raises important issues of cross-border implementation and coordination relates to the calculation of an international bank's consolidated operational risk capital charge under Pillar 1. Several observers have noted that the AMA approach to operational risk measurement under Basel II will permit international banks to hold enterprise-wide capital for operational risk that is lower than the sum of the individual operational risk capital charges that would be required if they were separately computed. The operational risk charge differs in this regard from the credit risk charge, which is additive on a consolidated basis. In addition, many of the data issues surrounding operational risk are compounded when looking at a legal entity level owing to the scarcity of relevant operational risk data. Consequently, a bank will realistically only be able to perform an AMA calculation at a consolidated group level under the auspices of its home country supervisor.

This unique characteristic of the operational risk capital charge has raised questions regarding the extent to which host country supervisors may look to allocate operational risk capital to entities within their jurisdiction. Attempts to allocate operational risk capital on a cross-border basis implicate directly the concerns noted above regarding home and host country coordination. In this context, like the contexts noted above, we believe that clear international standards for deference to home country supervisory authorities—including in the development of an apportionment methodology to generate legal entity capital requirements—as well as procedures for resolving differences in supervisory judgments are critical.

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G. Disclosure Requirements under Pillar 3

As discussed below, the Institute's members have significant concerns regarding the disclosure requirements of Pillar 3 generally. In the context of cross-border implementation, however, the Institute believes it especially important that the Committee clarify that required disclosures apply only at the top-tier consolidated level (*i.e.*, not for any individual bank subsidiaries of the parent bank or parent holding company). The language of CP3 indicates that Pillar 3 would apply "at the top consolidated level of the banking group to which the Capital Accord applies (as indicated above in Part 1: Scope of Application)." Because Pillar 1 potentially applies on a sub-consolidated basis to internationally active banks within a banking group, the description of the scope of application of Pillar 3 is not entirely clear. In the Institute's view, market disclosure that meets Pillar 3 requirements on a consolidated basis should be required only at the top-tier level and not at the level of any lower-tier banking organization. In this regard, we would encourage the Committee to clarify that the home country supervisor is responsible for (1) establishing disclosure requirements to implement Pillar 3 and (2) evaluating under Pillar 2 a banking organization's disclosure under Pillar 3.⁵ The need for appropriate deference to home country disclosure standards is particularly important as the Pillar 3 disclosure requirements become more discretionary (a trend the Institute supports, as described below in Part II.A).

H. The Role of the Basel Committee in Fostering Cross-Border Cooperation

Historically, the Committee has been the forum in which bank supervisors have developed international standards for the supervision of cross-border establishments of banks. This traditional role, coupled with the obvious role of the Committee in formulating international bank capital standards in Basel II, make the Committee uniquely suited to the development of standards and procedures relating to cross-border implementation of Basel II. Indeed, we would respectfully suggest that it is incumbent on the Committee to do so. No other organization or forum is qualified to set such standards or develop such procedures. Furthermore, the alternative—each international bank negotiating separately with its relevant host country supervisors—is in the Institute's view unworkable.

The Institute commends the Committee's formation of the AIG, and we fully support its active consideration of the issues raised in this letter and the other issues it is addressing. However, we believe that the AIG's discussion of these issues alone will not sufficiently address international banks' concerns without the development and publication of clear standards and, preferably, procedures to promote deference to home country supervisors.

⁵ We recognize, of course, that international banks that choose to list securities in markets outside their home countries may thereby become subject to disclosure requirements applicable to issuers in those markets.

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II. Other Issues

A. Market Discipline under Pillar 3

In general, the approach to mandatory disclosures under Pillar 3 described in CP3 reflects greater flexibility than prior versions, especially with respect to operational risk. However, our members believe that the Pillar 3 requirements set forth in CP3 relating to credit risk remain overly detailed and rigid. We fully recognize the value of transparency and market discipline in promoting an effective capital adequacy framework. Nevertheless, disclosures that are too voluminous to be useful to investors and other market observers or that are disproportionately burdensome on institutions will detract from, rather than promote, the goals of Basel II. Thus, without attempting to address specific disclosure requirements in this letter, we encourage the Committee to reconsider in particular the detailed credit risk disclosure requirements set forth in Part 4.B.4 of CP3.

B. Implementation Schedule

Many of our members believe that the Basel Committee's intended implementation schedule for Basel II is overly ambitious. The principal concern of those members who share this view relates to the operational risk capital charge calculation and the need to develop and adequately test operational risk management systems. While the Basel II implementation schedule to date has served as a catalyst for many institutions to accelerate their development of operational risk management systems, many of our members believe that the current schedule is unrealistic. Indeed, in order to qualify to use the advanced management approach to operational risk measurement, international banks would be required to have systems in place to capture data beginning January 2004, which is only months away. Particularly in view of the significant changes to Basel II that were reflected in CP3, and the fact that the details of the AMA would be left largely to the institution and its supervisor, many of our members have serious questions whether the current implementation schedule will give banks and their supervisors adequate time to implement the operational risk capital charge requirements of Pillar 1.

In addition, many of our members question whether the data generated through the Committee's Third Quantitative Impact Study ("QIS3") is adequate to assess the competitive effects of Basel II and the effects on different segments of bank's lending and other activities. While QIS3 produced more comprehensive and reliable data than the Committee's previous quantitative impact studies, even the QIS3 paper published by the Committee acknowledges significant deficiencies in the data. We understand that U.S. supervisors will be conducting at least one, and possibly two, further quantitative impact assessments in coming years, and these efforts necessarily raise the question whether the Committee and the various national supervisors have the data required to determine whether the Basel II framework can be implemented effectively without further modification at the international level.

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

Very truly yours,

A handwritten signature in black ink that reads "Lawrence R. Uhlick". The signature is written in a cursive style with a large initial 'L' and 'U'.

Lawrence R. Uhlick
Executive Director and
General Counsel