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November 3, 2003

Public Information Room
Office of the Comptroller of the Currency
250 E Street, SW
Mailstop 1-5
Washington, DC 20219
Attention: Docket No. 03-14

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

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Re: Docket No. R-1154

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2003-27

Re: Advance Notice of Proposed Rulemaking Regarding Risk-Based Capital Guidelines: Implementation of the New Basel Capital Accord

Dear Sir or Madam:

Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to comment on the advance notice of proposed rulemaking (ANPR) regarding the New Basel Capital Accord (Basel II) and how it should be implemented in the United States. The banking agencies (Agencies) are soliciting comment on all aspects of Basel II and will seek further changes to the new accord based on the comments that are received in response to the ANPR.

Background to Basel II

The current risk-based capital adequacy rules, adopted in 1989, are based on the International Basel Capital Accord of 1988 (Basel I). Although developed for large, internationally active banks, U.S. regulators applied these new risk-based standards to all domestic banks. Specifically, Basel I requires all banks to maintain a minimum total risk-based capital ratio of 8 percent, Tier I capital to risk-weighted assets of 4 percent, and a leverage ratio of 4 percent. For well-capitalized banks, those percentages are 10, 6 and 5, respectively.

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[1] ICBA is the nation's leading voice for community banks and the only national trade association dedicated exclusively to protecting the interests of the community banking industry. ICBA has some 4,600 members with branches in more than 17,000 locations nationwide. Our members hold more than $526 billion in insured deposits, $728 billion in assets and more than $405 billion in loans for consumers, small businesses, and farms. They employ more than 231,000 people in the communities they serve

Over the past several years, the Basel Committee on Bank Supervision has been working to develop a new regulatory capital framework that recognizes new developments in financial products, incorporates advances in risk measurement and management practices, and more precisely assesses capital charges in relation to risk. Although Basel I was a stabilizing force for the international banking system, the Basel Committee wanted a more updated accord that recognized the increasing complexity of the financial system. On April 29, 2003, the Basel Committee released a revised accord--Basel II-- for comment and on August 4, 2003, the Agencies issued the ANPR soliciting comment on the new accord and how it should be implemented in the United States.

Overview of Basel II

Basel II encompasses three pillars: minimum regulatory capital requirements, supervisory review, and market discipline. Basel II does not change the definition of what qualifies as regulatory capital or the risk-based capital ratios mentioned above. Under the first pillar, a banking organization must calculate capital requirements based on exposure to both credit risk and operational risk. Although the new accord provides several methods for determining capital requirements for both credit and operational risk, the advanced internal ratings based (A-IRB) approach is the method that the Agencies intend to apply to the largest banks in this country. Under the A-IRB approach, a bank's own assessment of key risk factors for a particular exposure serve as the primary inputs in the calculation of the bank's risk-based capital requirements. These risk factors are then inserted into formulas specified by the Agencies to derive a specific dollar amount capital requirement for each exposure or group of exposures.

To calculate credit risks, for instance, banks using the A-IRB approach assign assets and off-balance sheet exposures into one of three portfolios: wholesale (corporate, interbank and sovereign), retail (residential mortgage, qualifying revolving, and other), and equities. For each portfolio, banks then calculate a probability of default (PD), a loss given default (LGD), and the exposure at default (EAD) to determine the amount of capital that would be required for that portfolio. Under this first pillar, banks also have to hold enough capital for exposure to operational risk (defined as the risk of losses resulting from inadequate or failed internal processes, people, and systems, or external events) and use their own methodology for assessing exposure to operational risks.

The second pillar of Basel II—supervisory review—focuses on the regulatory review that would be necessary to ensure that a bank holds sufficient capital given its overall risk profile. Since banks are already required to hold capital sufficient to meet their risk profiles under Basel I, the Agencies are not proposing anything new under the second pillar. Existing rules such as the prompt corrective action rules would continue to be enforced and supplemented as necessary to ensure that an institution holds sufficient capital given its overall risk profile.

Under the third pillar—market discipline—specific disclosure requirements would be applicable to all banks using the A-IRB approach of Basel II. Banks would have to disclose in their public financial reports or in regulatory reports on a quarterly basis, their risk management policies for each separate risk area and their exposures to credit and other types of risks. This would allow shareholders and debt holders to assess a bank's capital structure, risk exposures, risk assessment processes, and capital adequacy.

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Limiting the Scope of Basel II

The Agencies plan to apply Basel II's A-IRB on a mandatory basis to only the large, internationally active U.S. banks that either have total commercial bank assets of $250 billion or more or foreign exposure of $10 billion or more. Other banks would be able to opt-in to Basel II but would have to meet certain supervisory standards to do so. The Agencies anticipate that approximately ten U.S. banks would be required to use Basel II (core banks) and that another ten or so banks would opt-in. All other banks would remain subject to Basel I.

ICBA applauds the Agencies for their plan to limit the applicability of Basel II to only the largest, internationally active banks that meet certain infrastructure requirements. If the objective of Basel II is cross-border competitive equality, only a handful of the largest banks should be involved since they account for most of the international banking activities conducted by U.S. banks. Collectively, the Agencies estimate that the 20 or so banking organizations that will comply with Basel II account for about 99 percent of the foreign assets held by the top fifty domestic US banking organizations, and for approximately two-thirds of the domestic assets of U.S. banking organizations.

Furthermore, methods of assessing capital adequacy must be appropriate to the size and complexity of operations of the bank. Bank consolidation in the United States continues to bifurcate the industry into a barbell shape with a few large, complex, globally active institutions on one end, and thousands of smaller, noncomplex, community-focused institutions on the other. In our view, capital adequacy regulations must recognize the increasing differences between these two ends of the spectrum.

The A-IRB approach is also infeasible for community banks and most likely will remain so in the future. Community banks do not have the resources to use sophisticated internal risk rating models—which are overly complex and too costly for their needs—that meet the Basel II requirements. A community bank is not likely to have a sufficient volume of credits to maintain a sophisticated, statistically valid model with the requisite degree or range of meaningful risk refinement to justify the high costs associated with the extensive data collection, record keeping and maintenance of the model. In short, Basel II would be overkill for community banks, and the costs and burdens of adhering to Basel II would outweigh the benefits, if any, of moving to the new accord for most community banks.

Competitive Concerns

Although ICBA is pleased with the proposal to limit the applicability of Basel II to only the largest, internationally active banks, ICBA still has concerns about the impact Basel II will have on community banks. In particular, **community banks are concerned that Basel II may place them at a competitive disadvantage because the A-IRB approach will yield lower capital charges for residential mortgage, retail and small business loans, which are the bread and butter credits of community banks.**

Larger banks that have the resources and capability to apply Basel II will choose it over Basel I if they perceive it to be in their best interests to do so. Under the A-IRB approach, various types of credits will enjoy much lower risk-weights and correspondingly lower capital charges than

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under the Basel I. The Basel Committee intends the lower minimum capital requirements associated with the more sophisticated methods to provide an incentive for banks to adopt the costly, more advanced risk assessment and management techniques. Thus, banks using the A-IRB approach can be expected to use Basel II to keep their capital levels very tight. The resulting relatively higher minimum capital thresholds for community banks could put them at a potential competitive disadvantage.

A review of the Basel Committee's Quantitative Impact Study 3 (QIS3) heightens our concern in this regard. Analyzing Basel II's impact on more than 300 individual banks, QIS3 compares the average risk weights and capital charges for various credit portfolios required by the current Basel I accord with those required under Basel II. Average risk weights and capital charges for some types of credit and asset portfolios would increase. But for retail credits, including mortgage and non-mortgage loans to individuals and small businesses—the very credits where community banks compete with large banks—the risk weights and capital charges would significantly decrease. For example, total retail credit capital charges under the A-IRB approach are estimated to decrease by 50% (60% for mortgages, and 41% for non-mortgages) among the banks in the G10 market area. At a recent meeting of bankers, one regulator estimated that the capital requirement for mortgages could be as low as 1.6% versus the 4% that is presently required.

Since there is a cost to a bank for maintaining capital, the lower capital requirements may result in a cost advantage, and correspondingly a pricing advantage, in retail credits for large banks that are subject to Basel II. The lower capital requirements will also make it easier for the Basel II banks to achieve a higher return on equity (ROE). In order to compete with the cost advantage and the higher ROEs of Basel II banks, community banks may be forced to make concessions in pricing and underwriting guidelines that could impair their profitability, and ultimately their viability.

While it is true that community banks hold more capital than other banks, one should not conclude that regulatory capital levels have little or no influence on loan pricing. The pricing and structure of loan transactions can be influenced by the impact of capital and the desired rate of return on the capital held against the loan. While other factors such as the cost of funds and local market competition can have a greater influence over loan pricing, regulatory capital is a factor. And since the goal of Basel II is to achieve greater alignment between regulatory capital and economic capital, for Basel II banks regulatory capital will likely have an even greater impact on pricing.

Community banks play not only a strong role in consumer financing in this country but also an important role in small business financing. Commercial banks are the leading suppliers of credit to small business, and community banks account for a disproportionate share of total bank lending to small business. Community banks account for 33 percent of small business loans, more than twice their share (15%) of banking assets. Because of the important role small businesses play in the economy (more than half the private sector workforce and two-thirds to three-quarters of new jobs), it is imperative that the Agencies consider the competitive impact Basel II will have on community banks and their customers.

ICBA commends the Agencies for questioning the results of the QIS3 and calling for a fourth Quantitative Impact Study. QIS3 has generated more questions than answers and no one is really sure of the competitive impact of Basel II to the banking industry, least of all community

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bankers. Both the Agencies and the industry would benefit from another study to more accurately show the impact that Basel II will have on the capital of the largest banks and what competitive effect that impact will have on community banks. We strongly encourage the delay of any further movement of Basel II until the results of QIS4 are collected and analyzed.

More Consolidation

ICBA also fears that Basel II will further accelerate consolidation in the banking industry. Lower capital levels that large banks obtain under Basel II will likely result in more acquisitions by the larger banks seeking to lever capital efficiencies. As more of the larger banks opt-in, over the long-term this may threaten the viability of community banking. Since most community banks will remain under Basel I, they will have difficulty competing against bigger Basel II banks that benefit from reduced capital requirements and higher ROEs. Basel I banks will become likely takeover targets for Basel II banks that believe they can deploy Basel I bank capital more efficiently. As more Basel I banks are left with riskier assets, lower credit ratings and higher costs of liabilities, they will find it more difficult to compete for the higher quality assets.

If Basel II is implemented, Basel I banks are also concerned that they will be considered "second tier" institutions by the market, the rating agencies, and sophisticated customers such as government or municipal depositors and borrowers. Rating agencies, for instance, may look more favorably upon Basel II banks resulting in these institutions gaining market share against those that cannot comply. Second tier institutions will be more interested in merging with the larger, first tier institutions, ultimately resulting in an acceleration of consolidation for the industry. Excessive consolidation will reduce competition and access to financial institutions in many markets and will have a negative impact on customer service.

Implementation Concerns

Implementing Basel II will present enormous challenges to the banking industry and to the Agencies. Banks that are required to adopt Basel II or elect to do so will have to devote considerable resources to implement it. Estimates range from $10 million for smaller banks to upwards of $200 million for the very largest banks. When one multiplies these costs by the number of national and international banks within the banking system, the figure is very high. Unfortunately, these costs are likely to be passed on to consumers and corporations who deal with Basel II banks.

While one can argue that Basel II banks would incur some of these compliance costs anyway by seeking to upgrade their internal risk management systems, most of the costs would be due to the unnecessary complexity of Basel II. Even Comptroller Hawke has admitted that Basel II is "not only complex, it is virtually impenetrable." It is so complex that it will be difficult for banks to find competent employees who will understand it. Basel II banks will be forced to hire consultants to evaluate credit and operational risks and to help create internal estimates of risk inputs. Sophisticated software programs and upgrades will be needed to compute the capital formulas and to calculate the capital requirements for each portfolio of assets. Auditors, both internal and external, will need to be trained under the new rules and will need to be familiar enough with the bank's own internal estimates of credit and operational risk so that they can certify as part of their internal control report that the bank is in compliance with Basel II. Bank directors

will likely find Basel II and internal models that implement it almost impossible to understand other than in a broad, conceptual way.

Moreover, the Agencies will find it difficult to find sufficient talent to fill their ranks, especially when they will be competing for PhD-level expertise against the large banks. Examiners of Basel II banks must be qualified and have sufficient expertise to understand the bank's model or formula and its assumptions and limitations. As examiners leave and are replaced, it will be hard to maintain institutional memory regarding a bank's set of formulas for determining its credit or operational risk. The Agencies will also have the challenge of maintaining consistency among themselves in examining Basel II banks.

ICBA recommends that the Agencies consider ways of simplifying Basel II. A more simplified rule would facilitate its implementation and supervision and will reduce the compliance costs that will ultimately be passed on to bank customers. A simpler Basel II would also lessen some of the competitive disparities that will invariably exist with a bifurcated capital approach.

Risks to the Banking Industry

ICBA is also concerned about the special risks that Basel II poses to the banking industry, the Bank Insurance Fund and the Savings Association Insurance Fund, especially if Basel II banks reduce the percentage of capital they hold. The Agencies must be mindful of the conflict of interest inherent in using internal capital allocation models to both optimize profitability and increase returns on the one hand, and determine adequate capital levels on the other. Institutions that apply Basel II's A-IRB approach will have incentive to understate risk and losses in order to reduce capital requirements and increase return on equity. To guard against this, methods of ensuring accountability on the part of institutions using the A-IRB approach must be part of Basel II so that safety and soundness is not jeopardized.

Under the A-IRB capital scheme, regulators will ultimately be responsible for ensuring institutions maintain adequate capital levels and must be very careful to assure the suitability and validity of IRB models, which may prove to be a daunting task. Only those institutions that are truly qualified to use the A-IRB approach should be permitted to do so. Mistakes or faulty judgments will have far reaching implications as regulators face the challenges of supervising large, complex banking organizations whose failure or disruption of operations present systemic risk to the domestic and global financial system and economy. And, because of its impact on the BIF and SAIF, all banks will pay the price in such an event, not just Basel II banks.

ICBA agrees with the Agencies that the existing leverage ratio requirements under prompt corrective action legislation and implementing regulations should be maintained, including a minimum 5% leverage ratio, to be classified as "well-capitalized." This will ensure that, regardless of the risk-based capital model used by a Basel II bank, there is a base level of capital available in the event of a crisis.

Parity Between Basel I and Basel II

If Basel II is implemented, ICBA recommends that further changes be considered for Basel I to enhance its risk-sensitivity and to address any competitive equity concerns associated with a bifurcated framework. If, for instance, the capital requirement for mortgages

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drops as low as 1.6% as one regulator has predicted for Basel II banks, then Basel I should be changed so that the Basel I banks can also adjust their regulatory capital as compared to the 4% that is now required. The Agencies should also consider additional risk categories to enhance the risk-sensitivity of Basel I and to align capital requirements with risk levels. The risk-weighting of these categories should also be modernized to better match current knowledge about actual risk exposures. For instance, lesser risk weights could be considered for rated credits and conforming mortgage loan products. Additional risk categories could be added for loans with low LTV ratios. However, because Basel I includes a buffer for risks not easily quantified (e.g., operational risk and concentration risk), Basel I banks should never be subject to an additional direct capital charge for operational risk.

If the new QIS4 confirms the disparity in capital charges for retail credits that QIS3 showed, then ICBA recommends that the Agencies begin an immediate reevaluation of Basel I to determine how parity can be reached between the two frameworks. During that process, ICBA hopes that the relative simplicity of Basel I is preserved. There is no need to make Basel I unnecessarily complex in order to enhance its risk-sensitivity or to bring it into parity with the A-IRB approach of Basel II.

Conclusion

ICBA commends the Agencies for their dedication and for all the hard work that has gone into creating Basel II. ICBA also commends them for limiting the applicability of Basel II only to the large, internationally active banks in the United States that can comply with certain infrastructure requirements. The A-IRB approach is simply infeasible for community banks and most likely will remain so in the future. At the same time, ICBA fears that Basel II will have an adverse competitive impact on community banks and will further accelerate consolidation in the banking industry. Hopefully, a new QIS4 will shed more light on the impact of Basel II and the competitive concerns of community banks. Finally, if Basel II is implemented as proposed, ICBA recommends that further changes be made to Basel I to enhance its risk-sensitivity and to address any competitive concerns associated with a bifurcated framework.

If you have any questions or need any additional information, please contact Chris Cole, ICBA's regulatory counsel at 202-659-8111 or Chris.Cole@icba.org.

Sincerely,

C.R. Cloutier
Chairman