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Overview

This letter is in response to the interagency request for comment on the proposed implementation of the new Basel Capital Accord in the United States ("ANPR"). In general, BOKF supports the concept of economic capital as a strategic tool for both bank management and regulators; however it is important to recognize the significant subjectivity associated with measures of economic capital. Until guidelines are issued to reduce this subjectivity, BOKF is concerned that a regulatory mandate of "Pillar 1" of the new Basel Accord ("Basel II") as a regulatory capital minimum for larger banks could create an un-even playing field, hurting smaller banks and potentially causing a systemic shift of low credit quality from large and more sophisticated banks to banks less well technologically positioned. This response to the RFC offers suggestions for alleviating our concerns.

To the extent that Basel II minimum capital requirements go against current industry "best practices" for measuring economic capital, we believe there is a high probability that adopting the ANPR as presented will force either:

a) internal models to be less representative of actual economic risk, and thereby cause economically suboptimal decisions, or
b) individualized highly sophisticated systems that arrive at different results and obfuscate comparability across financial institutions.

Before addressing three of the questions for which you requested comments we present some areas where we seek more regulatory guidance. These cover "best practices" and should be clarified before regulatory adoption of the new Basel Capital Accord.

1) Is use of economic capital for determining, in whole or in part, capital adequacy a best practice to which all financial institutions should move?

   We believe it should be. Further, all commercial banks should currently be able to do so to some extent. Differentiating credit quality within all credits currently risk weighted at 100% is a standard that is expected of all commercial banks irrespective of size. Similarly, all commercial banks are expected to evaluate their asset-liability exposure and manage the corresponding interest rate and liquidity risk. Finally, all banks that are members of the Federal Reserve System are required to evaluate their operational risk and manage it through prescribed controls and by purchasing a fidelity bond to risk transfer unmanageable operating risks.

   Thus, both banks and regulators are able to stratify commercial banks across a continuum of risk profiles for credit, ALM, and operating risks. Those at the high end of this risk profile continuum should be required to have higher capital and expected earnings, and we believe regulators are adopting this approach, at least subjectively, today.

2) Should minimum regulatory capital require components for credit, ALM, operating, and market risks, rather than just the credit, operational, and market described in the ANPR?

   Again, we believe it should. While we acknowledge that credit and operating risks are commonly the largest components of risk for a financial institution, ALM risk has caused banks, and particularly Savings and Loans, to fail. Capital should be held to protect against this. Interestingly, we feel the 1988 accord, which was ostensibly credit oriented, arrives at a good aggregate figure for economic capital that includes credit, operating, ALM, and market risk.

3) How should geographic or industry concentrations be penalized, or diversification rewarded, in a best practice adoption of economic capital?

   We believe that undue concentration in an industry or geography can lead to unexpected losses against which economic capital should be kept. We note that the ANPR "neither rewards nor punishes" concentrations and correlations, other than the diversification benefits proposed for high probability of default loans. We believe it is important to

recognize the diversification benefits achieved through geographic and industry distribution, for all credit exposures.

Below, we address three of the questions posed in the ANPR which we feel speak to potential uneven playing fields.

1) "To the extent that advanced approach institutions have lower capital charges on certain assets, how probable and significant are concerns that those institutions would realize competitive benefits in terms of pricing credit, enhanced returns on equity, and potentially higher risk-based capital ratios?"

We believe that the pricing ability of a given organization is dependent upon their external credit rating rather than the measure of regulatory capital. If external rating agencies believe that lower, regulator-approved minimum capital calculations imply lower default risk, rating agencies might upgrade an advanced institution's debt rating. In that case, such institutions would have significant advantages over banks following the general model. Advanced banks could better differentiate risks, target their market, and price competitors out of that market. Mid-size banks with less sophisticated economic capital models but with otherwise identical risk profiles to their larger competitors would be priced out of key lending and fee-based businesses such as underwriting, derivative products, and funding opportunities.

Smaller banks, with fewer risk management resources and expertise could easily be left with greater numbers of lower quality loans, less ability to determine the risk of those loans, and therefore less ability to adequately price for the increased risk. In the trough of a credit cycle, this high margin business, if not properly managed, could cause failures. Mid-sized banks better able to quantify and price for risk could be priced out of the market by those with less information, creating a short-term problem for mid-sized banks, but a long-term problem for smaller banks.

2) "Specifically, the Agencies invite comment on the domestic competitive impact of the potential difference in the treatment of reserves described."

The revised AIRB proposed treatment of provisions relative to expected loss creates an incentive for advanced banks to tolerate larger than expected loss exposures as it gives them some credit for provisions in excess of the expected loss portion of the IRB capital requirement. We believe a higher expected loss ("EL") asset also has a higher unexpected loss ("UL"). Thus, a higher expected loss should increase total economic capital required. At issue, then, is whether the increase in economic capital to cover UL offsets the benefit of allowing 20% of the "excess" of provisions over expected loss into Tier II capital, even that excess is greater than 1.25% of risk weighted assets. With a well-diversified loan portfolio, we expect the unexpected loss would not increase by as

much as expected loss. Therefore, a well diversified bank that adopts AIRB will have a capital advantage over a well diversified bank that does not adopt. With concentrated loan portfolios, unexpected loss would likely increase by more than the expected loss, and a bank that adopts AIRB would actually be disadvantaged to one who does not adopt.

Based on this premise, allowing a provision excess over expected loss, even if greater than 1.25% of RWA could lead to a diversification of loan portfolio in opt in and mandated banks while allowing increased concentration in opt out banks. The systemic implications of this are unclear to us. On one hand, this would lead to increased credit risk profiles in the least sophisticated financial industry players. On the other hand, it could lead to specialty lending among regional banks where customers could be better served.

3) "In particular, the Agencies seek comment on whether any changes to the general risk-based capital rules are necessary or warranted to address any competitive equity concerns associated with the bifurcated framework."

As the proposed new regulatory framework stands, there is inadequate guidance regarding what the appropriate goal for small and mid-sized banks should be. There is no regulatory incentive to move to a more risk-sensitive capital framework: there are no ALLL benefits, there are no possible capital reductions. All incentives for increased risk-sensitivity for small and mid-sized banks stem from the marketplace, not from regulatory benefits. To be consistent with the goal of more closely aligning regulatory capital with economic capital, there should be an interim level of sophistication that does give some incentive for small and mid-sized banks to progress along the economic capital path.

Conclusion:

Banks will be more efficient and the worldwide banking system will be sounder if risks are better measured and managed. Economic capital goes a long way towards this goal. However, a system in which some banks' regulatory capital is based on their measure of economic capital while others' reflect a more arbitrary standard, creates two separate markets where only one exists. The bigger players, with considerable flexibility in determining economic capital, could create a competitive advantage over smaller rivals, potentially leading to consolidation which we feel is not good for consumers or for safety and soundness. However, a prudent set of "economic capital" best practices set forth by regulators, allowing a compromise standard for mid-sized banks that strikes a balance between risk-sensitivity and comparability, would move the banking system towards more risk based capital framework that improves risk management at the bank management and regulator levels.

Best Regards,

Bank of Oklahoma, N.A.

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