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Docket Nos. 06-09 and 06-10

Re: Risk-Based Capital Standards: Advanced Capital Adequacy Framework 71 FR 55830 (September 25, 2006)

Greetings All!

We are consultants and appraisers for the banking industry, and are glad to offer our comments on the Risk Based Capital Standard: Advanced Capital Adequacy Framework Notice of Proposed Rulemaking (the "NPR"). This is issued collectively from the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, herein referred to as the Regulators.

There has been a great deal written and discussed as to the deviations between the current US NPR and the International Basel II Accord. Many of the publicly displayed comments are very concise in articulating view points. However, one important question comes to mind; why are there these deviations. Some of the objections are with definitions, others with conversions timing or multiple standards of risk (retaining Basel I, and adding Basel IA and Basel II). Again the question remains of why?

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When one reviews the results of Quantitative Impact Study 4 (QIS4) they can not help noticing the suggested massive reductions in the Minimum Capital Requirements (MCR) by as much as 15%. This is so significant that if capital levels were recomputed overnight, Regulators may be prompted into corrective action, based on existing regulations.

So it is easy to understand the trepidation that Regulators may experience when reviewing the results of such findings as the QIS4. Fear or concern can often be a powerful motivating force, which may explain the divergence between the International Basel II proposal and the American proposal. If it is concern that motivates an American path out of step with the balance of the world, can the concerns be addressed and eliminated?

Again, when one considers massive reductions in the MCR, this may at first look seem alarming, but is it truly so? The definitions of risk and related computations of capital are intended to be very precise. The argument is that as the reliability of the precision increases, the need for a large cushion diminishes. One can liken the example of a game of darts. Suppose the center target represents the size of the MCR. If one has poor eyesight, the center may be the size of a large serving dish. But as eyesight improves, the center target could be reduced to the size of penny.

In a real sense, one could argue that over the past 15 or 20 years the financial eyesight of corporate America (including banking or other) has significantly improved. The writer graduated almost 20 years ago, and desktop computers were in the early stages of being adopted. There was no technical ability to compute according the Pillar I definitions on a timely basis. How many of the persons commenting can still remember writing in the manual bank ledgers?

The traditional views (and definitions) of MCR were derived because banks simply could not sufficient technical data on a routine and timely basis. How many those offering comments to this NPR had the technical ability to report even five years ago?

The reward of technical innovation should be efficiency, and history proves this true. There is a general agreement that the existing NPR penalizes technical innovation by failing to offer the reward, an accord that is in agreement with the International Basel II Accord.

Whenever one considers a Paradigm Shift, there is always a great deal of nervousness. This can lead to half steps, one step back for each foreword, imposition of questionable thoughts, limits, etc. It would seem this is the explanation for the divergence between the American NPR and the International Basel II Accord.

If one can lay fears or concerns down, there can be a systematic examination of all issues. It is true that American banks can compete effectively and efficiently if freed from unreasonable or inconsistent constraints. Technology exists now to allow timely and routine reporting according to the existing definitions of the International Basel II Accord. While not attempting to point any fingers of accusation in any direction, it is important for Regulators to ask why the divergence and is it necessary?

We have noted in several comments a variety of questions over this or that. We have found that sometimes there can be value in considering a problem upside down.

Starting with the Third Pillar, Market Disclosure, three logical questions are how, when, and why? It is suggested that the How be in a form similar to a Call Report. This is an existing report that is well known as standard financial information. Since this report exists and most banks are familiar with the form, it is logical to add the capital requirements and positions to this existing report. There are companies now that publish reporting software and could easily update the existing electronic reporting.

The next question is when, and the suggestion is quarterly. There would be an investment in developing the reporting routine, after which electronic reporting of the MCR could be completed with the balance of the call report. Quarterly is an important timeframe in finance. Conditions can change from one quarter to the next, and such reporting would give very timely results and trends to Regulators.

The final question is why? It has been stated above that efficiencies can be the reward of technical innovation. If one were to deploy technologies that allow reporting in agreement with the International Basel II Accord, then the reward could be a reduced MCR. So one could say the Market Disclosure would be proceeds of an investment in compliance; the proof of adoption of the new international standards.

There has been talk of an extended timeline to comply, and of several standards (Basel I, Basel 1A, and Basel II). Why? There is an old saying that a camel is a nothing but a horse designed by committee to please all. American banking does not need a camel. Consider the existing Call Report form. Most banks fill this out, but not all banks fill out all parts. Also is the tax example. All fill out the same tax form, but not all use the same schedules. If not all components apply equally to all banks, large and small, why not just fill in the applicable parts?

We have seen the regulators state that a multi tiered approach is needed, but not ***why***? Is the issue cost or complexity? Consider the example of Sarbanes Oxley (SOX) compliance, there are accelerated and non accelerated filers. The non-accelerated generally have a greater time to comply and are the smaller firms. By

the time of the completion of the first round of compliance, consulting firms have developed systems of compliance. When non accelerated filers need to comply, consultants can sell services at a reduced price and frequently the cost of meeting regulation (such as SOX) is more price competitive. So those smaller companies are still held to the same rules, but may have a price advance in compliance. This may knock out the argument of excessive complexity or price.

The next area is Supervision. To this end there are two points of view, those being supervised and the actual supervisors. If one considers there are four federal regulators, plus state regulators, possibly debt or equity market regulations, then add the three separate proposed rules on top (Basel I, Basel IA, and Basel II), the ability to meet demands of diverse supervisors almost entails supreme juggling skills. Just ask any banker to name any year when there were consecutive two months of no examiners of any type at the bank. Banks spend an enormous amount of time now in conforming to supervision. Absent any clear, concise direction from existing regulators, the problem would compound. And all indications are the existing NPR is far from clear and concise.

The second point of view is that of the supervisors. There has been much written about the ability of Regulators to understand and follow the new risk calculations. Certainly when an audit manager of any of the Regulators looks upon any of the new calculations, a question which comes to mind is “can my staff handle this?” Is this not the same question ask all those years ago when audit managers first were shown pictures of laptop computers? Yet who audits manually now?

There have been questions raised about the availability of supervisor manpower and technical skills. When considering from the bottom up, a regulatory auditor would have a copy of the reported MCR, then begin the auditing process. This would likely involve the ability of a laptop computer and applying existing formulas to portfolios, or just routine testing. Then one could test various components of the portfolio to ensure compliance, independent ratings are present and accurate, independent pricing or valuing, accurate loan loss reporting, etc. Now how challenging does this sound?

We would suggest the true key component in this pillar is to have a plan where confidence is vocalized by the banks themselves. There is existing criticism about being out of sync with the rest of the world on key issues. So it is up to the supervisors to develop a plan that a majority agree, is workable. Many large banks have offered excellent comments on detailed points, calculations, contradicting definitions, etc. Rather than restating what colleagues have clearly discussed, we come back to our earlier question, why do regulators feel the need to have a plan divergent from the international accord. Is the reason due to fear of the unknown or fear of change.

Supervision is not only monitoring a situation with existing rules, but validating and explaining new rules. This is not a criticism but a question; where are the valid

reasons for a divergent path? If the reasons are less than solid, follow a single accord.

Now is the First Pillar. This has to due with the MCR computations for various risks. Again there are many excellent existing comments as to definitions and mathematics. Rather than offering a restatement of what others have stated so well, we find one point of interest. There is concern as to having a regulated bank developing internal models of risk? This is curious, and similar asking a person to fill out their own annual review. Must it be a paradox to say, "Mr. Regulator how can my MCR computation be wrong when I define my own parameters?" In the International Basel II Accord it is stated that the committee will continue to work closely with the accounting profession to maintain consistency. In America if there were a significant failure in computation of the MCR lead to a possible violation of Sarbanes Oxley and the potential for significant penalties?

Consider that the largest international banks may have a similar number or type of products and services. Also consider key differences between the banks may be the mix, location and interest rates. This is where management styles, techniques, etc come into play.

If the mathematic equations for MCR computations are set, and the parameters are clearly defined, what then are the true variables? Are the only true variables the results of operations of my bank at my direction?

Suppose that from one period to another my HELOC losses quintuple. Could this change my MCR, yes. Does a change in my operations mean that my competitor now must change their MCR, no. Is the change in my position quantifiable and available for supervisory review, yes.

There is much discussion as to looking foreword to compute the MCR. As long as I also take into account my current and recent operations, there is solid, foundation for computations.

In conclusion, one large question seems to remain. Do we want a very simple definition of risk and cover it with a very large bucket of MCR, or do we want a surgically precise definition of risk and cover it with a smaller, specific definition of MCR. In all other areas of life, precision is yielding great results, medicine, newly efficient automobiles, smaller and more robust computers, etc. Perhaps it is time for American banking to follow the world in this trend.

Sincerely,

Timothy J. Alexander
Senior Vice President