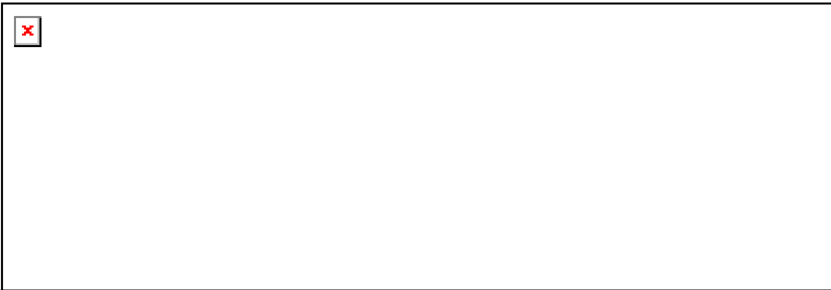

JAMES P. GHIGLIERI, JR.
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Chairman-Elect
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WILLIAM C. ROSACKER
Secretary
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Immediate Past Chairman

CAMDEN R. FINE
President and CEO

March 26, 2007

Office of the Comptroller of the Currency
250 E Street, SW
Mailstop 1-5
Washington, DC 20219
November 9, 2005

Attention: Docket 06-09

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments/Legal ESS
RIN 3064-AC73

Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street an Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1261

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn: No. 2006-33

Re: Risk-Based Capital Standards; Advanced Capital Adequacy Framework

Dear Sir or Madam:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to offer comments on the Notice of Public Rulemaking (Basel II NPR)

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[1] *The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than $876 billion in assets $692 billion in deposits, and more than $589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

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INDEPENDENT COMMUNITY BANKERS *of* AMERICA *The Nation's Voice for Community Banks*
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issued by the banking agencies and published in the *Federal Register* on September 25, 2006 regarding a new risk-based capital adequacy framework. The new framework (Basel II) would require some and permit other banks to use an internal ratings-based approach (IRB) to calculate regulatory credit risk capital requirements and advanced measurement approaches (AMA) to calculate regulatory operational risk capital requirements.

Under the Basel II NPR, banks with consolidated total assets of $250 billion or more or with consolidated total on-balance sheet foreign exposures of $10 billion or more would be subject to the proposed Basel II rules. As of the date of the Basel II NPR release, eleven top-tier banking organizations met those criteria. Other banks would have the opportunity to opt-in to the new capital standards provided they receive the approval of their primary federal supervisor.

Since few if any of ICBA's members will be subject to Basel II, ICBA will focus its comments on the general concerns that community banks have about the implementation of Basel II in the United States.

ICBA's Position

ICBA Strongly Supports Retention of the Leverage Capital Ratio

As proposed in the Basel II NPR, those banks that are required to adopt Basel II and those banks opting in (the "Basel II banks") will remain subject to the tier 1 leverage ratio (e.g., tier 1 capital to total assets) and the prompt corrective action regulations mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). **ICBA commends the banking agencies for proposing to retain the tier 1 leverage ratio as part of Basel II. ICBA strongly believes that the retention of the leverage ratio is essential to maintaining the safety and soundness of our banking system and is a needed complement to the risk-sensitive Basel II framework that is based only on internal bank inputs and risk parameters.** Capital requirements under Basel II depend heavily on the answers to questions that vary from bank to bank and have no objectively best answer. No matter how refined a risk-based capital framework the regulators come up with, it cannot capture all risks. Accordingly, there will always be a need for minimum capital requirements to ensure adequate minimum capital levels and a base level of capital for safety and soundness in all economic conditions.

Furthermore, it is very important to our economy that regulators maintain a minimum capital cushion for our largest financial institutions that pose the greatest risks to our financial system. If a trillion dollar financial institution were to become significantly undercapitalized or fail, the consequences to the Deposit Insurance Fund, the rest of the banking industry, and our economy would be enormous.

As former Comptroller of the Currency John Hawke said before a Senate Banking Committee, "Reducing the leverage ratio would undermine our whole system of prompt corrective action which is the foundation stone of our system of supervision…I think we need to reach an appropriate accommodation where we try to make our basic system of regulatory capital rules more risk-sensitive, but we shouldn't do that at the price of dismantling or significantly impairing the basis for our supervision of U.S. banks."[2]

ICBA Strongly Supports the Transitional Floors and the 10% Tripwire

Under the proposed Basel II NPR, the Basel II banks will be able to conduct a parallel run beginning in 2008—calculating their capital using both the present risk-based capital rules of Basel I and the advanced approaches of Basel II. During a three-year transition period from 2009 to 2011, the Basel II banks would be subject to "transitional floors" that would limit the reduction of their minimum risk-based capital in any year to 5%. The transitional floor calculations would be linked to the current Basel I risk-based capital rules.

ICBA commends the banking agencies for proposing to adopt these transitional floors as well as committing to significantly recalibrate Basel II if, during the three-year transition period, there is a 10% or greater decline in aggregate minimum risk-based capital of the Basel II banks (without the effects of the transitional floors) as compared to minimum required risk-based capital as determined under the existing Basel I rules (the "10% tripwire"). ICBA believes that any change 10% or greater should warrant a fundamental change to the Basel rules. We appreciate the fact that the agencies have identified a numerical benchmark (e.g., 10%) for evaluating and responding to capital outcomes during the parallel run and the transitional floor periods. We are also concerned about the change in tier 1 capital of the Basel II banks during the parallel run and transitional floor periods and recommend that the agencies monitor the trend in tier 1 capital and take appropriate action if reductions are significant.

Capital Requirements Should Not Become a Tool For International Competition

ICBA commended FDIC Chairman Sheila Bair's recent comments before the Global Association of Risk Professionals during which she expressed serious concerns about the tenor of recent discussions about international competition and Basel II. **We agree that the agencies should never consider putting our entire banking system in jeopardy because a few banks claim that they need lower capital requirements to compete internationally.** As Chairman Bair explained:

> "For bank capital requirements to become a tool for international competition, creates the potential for a competition in laxity. A race to the bottom in bank

[2] Testimony before the Senate Banking Committee (April 20, 2004)

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> capital standards would be a profoundly negative development for the future stability and health of the global financial system. Strong capital is a strength, not a weakness. Likewise, any weakness in capital standards in foreign markets has the potential to spread instability to the U.S. banking industry."[3]

ICBA disagrees with those banks and industry groups who claim that the Pillar 2 Supervisory Controls of Basel II will provide adequate safeguards for the Basel II banks and that there is no need for a leverage requirement or transitional safeguards to protect against significant reductions of capital. As Chairman Bair indicated, the effectiveness of supervision can be completely undermined if the regulations do not require adequate capital. **ICBA believes that the only effective and safe means to ensure adequate capital and the safety and soundness of the banking system is to have minimum capital requirements like the Tier 1 leverage ratio requirement**. Capital is too important for the financial system to be subject solely to the judgment of an examiner. In the case of Basel II where capital amounts are based on the bank's own impartial inputs and risk parameters, it is even more important that the Basel II banks be subject to the leverage requirement and prudent safeguards to ensure that there is not a precipitous reduction in capital.

To ensure adequate capital for the Basel II banks and parity between the two accords, ICBA believes that the Basel II banks should continue to be subject to the Tier 1 leverage ratio requirement and the 10% tripwire after the Basel II transitional period ends even if there are different capital requirements between foreign and domestic banks. As the agencies point out in the Basel II NPR, the purpose of Basel II is not to reduce overall risk-based capital or to permit U.S. banks to compete more effectively internationally but to better align banking capital with risks. The safety and soundness of the banking system should not be jeopardized in the name of improving international competition for U.S. banks.

ICBA Remains Concerned about Basel II

Despite the transitional safeguards, the Tier 1 leverage ratio incorporated into Basel II mentioned above, and the efforts by the regulators to revise Basel I, ICBA remains concerned that Basel II will place community banks at a competitive disadvantage. The IRB approach of Basel II will yield lower capital charges for residential mortgage, retail and small business loans for Basel II adopters, the very credits where community banks compete with large institutions. An individual loan has the same risk to an institution whether a community bank makes the loan or a mega-bank makes it. It is not appropriate for the risk-based capital charge attendant to that loan to be widely divergent depending on whether the loan is made by a Basel II bank or a bank not subject to Basel II.

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[3] Remarks by Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation; before the Global Association of Risk Professionals; New York City; February 26, 2007

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The results of both the third and fourth Quantitative Impact Studies (QIS3 and QIS4) have confirmed our concerns about the competitive equities of the new accord. These studies showed dramatic reductions in capital for residential mortgage credits, small business credits and consumer credit. For instance, QIS4 indicated that for the Basel II banks, there would be a 79% median percentage drop in minimum required capital for home equity loans, a 73% drop for residential mortgage loans, and a 27% drop for small business loans. For all credits, risk-based capital requirements would decline by more than 26%. If one considers that the current minimum capital requirement under Basel I for mortgage loans is 4%, an average drop of 79% would mean that minimum capital requirements for the Basel II banks would be less than 1% for these types of loans.

An FDIC staff study included in the FDIC Basel IA Notice of Proposed Rulemaking[4] indicates that even with the implementation of Basel IA, the Basel II adopters will continue to have a significant capital advantage with respect to 1-4 family residential mortgages, home equity loans, small business loans, and other retail loans. For instance, median risk weights for 1-4 family mortgages would be 16% under Basel II whereas under Basel IA, they would be 35%. Median risk weights for a typical home equity loan would be 19% under Basel II and 100% under Basel IA. This study reconfirmed ICBA's fears that Basel IA will not eliminate the competitive inequities between the two accords.

Since there is a cost to a bank for maintaining capital, the lower capital requirements would most likely 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.

ICBA also fears that Basel II will further accelerate the consolidation in the banking industry. Lower capital levels that large banks obtain under Basel II will likely result in more acquisitions of smaller banks by larger banks seeking to lever capital efficiencies. As more of the larger banks opt-in over the long-term, this may eventually 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 returns on equity. 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

[4] See chart prepared by the FDIC staff on page 11 of the FDIC Basel IA release..

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costs of liabilities, they will find it more difficult to compete for the higher quality assets.

A paper released in 2005 by J.P. Morgan Securities Ltd London entitled "Basel II—And the Big Shall Get Bigger" concludes that if Basel II were to be adopted in its present form, the Basel II banks would have a "decisive competitive advantage" over other banks and will look to expand and arbitrage their capital by purchasing smaller, less sophisticated banks. As for the effect of Basel II on community banks, J.P. Morgan says:

> "It is difficult to see the future for the smaller community banks in this 'brave, new world'. This has not gone unnoticed as the S&P notes "U.S. community bankers are up in arms against Basel II, saying it gives an unfair advantage in leverage and pricing to large internationally active competitors over smaller domestic banking groups". This seems to be backed up by available information, from which it would appear that the large US and European banks are much more advanced in terms of implementing Basel II as well as likely to be big new beneficiaries of the process. We believe the best opportunities for smaller banks to combat this is perhaps through more cooperation with each other, to share data, bear costs and even swap assets. An alternative seems to be buying the risks that the bigger players do not want, which may mean the potential of adverse selection in credit risks. In our opinion, this is not a recipe for long-term success."

Community banks play not only a strong role in consumer financing in this country but also a critical 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% 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 to consider the competitive impact Basel II will have on community banks and their small business customers.

Basel II is Too Complex and Costly; ICBA Supports Allowing the Basel II Banks the Option of Using the Standardized Approach

ICBA has always been concerned about the complexity of Basel II and the ability of Basel II adopters to understand and implement the new accord as well as the consequences if a mistake is made. The wide diversity in the results from QIS4 suggests that Basel II is too complex and that banks will have difficulty in applying the new accord consistently. The two hundred page Proposed Supervisory Guidance for the Basel II released last month for comment illustrates how difficult it will be for Basel II to be implemented and supervised. **To reduce the costs and complexity of Basel II, ICBA supports allowing the**

Basel II banks the option of using the "standardized approach" of the new accord in lieu of the advanced IRB approach.

Since the Basel II requirements are very sensitive to inputs, achieving consistency will depend on the concept that every bank will eventually adopt a common method for estimating their risk inputs leading to a convergence in the capital treatment of similar loan portfolios across the Basel II banks. However, at least as indicated by the results of QIS4, there seems to be little commonality in the approaches that various banks used to estimate their risk inputs.

ICBA is also concerned about the high compliance and supervisory costs of Basel II. According to the Basel II NPR, nineteen of the twenty-six banks that participated in QIS4 indicated that it would cost $791 million over the next several years to implement the new accord. This estimate did not include the implicit costs of Basel II—the increased time and attention required of bank management to introduce and monitor the new programs and procedures. The OCC has estimated that its total 2005 costs for Basel II amounted to $7.1 million. Assuming that supervisory costs will increase during the Basel II transition period and that the other three banking agencies will incur comparable costs, it is easy to see that total supervisory and compliance costs for Basel II during the transition period will exceed $1 billion.

ICBA has recommended that the bank regulators consider ways of simplifying Basel II to reduce total compliance and supervisory costs and to ensure that banks will understand the formulas and apply them consistently. The new accord and its capital formulas should not be so complex that banks cannot consistently apply the formulas and come to similar conclusions. Regulators should be able to readily spot intentional or unintentional errors or omissions in the formulas that are used. Basel II should also be simple enough that bank directors can monitor its implementation and auditors can certify to them as part of their internal control audits.

To reduce the costs and complexity of Basel II, to enhance its flexibility, and to mitigate competitive disparities between the Basel II and Basel I banks, ICBA supports allowing the Basel II banks the option of using the "standardized approach" of the new accord in lieu of the advanced IRB approach. The standardized approach would provide a simpler and less expensive alternative for measuring credit risks and would be attractive option for smaller, less complex Basel II banks. The standardized approach would require fixed risk-weights to be applied to different assets much like Basel 1A and would align risk weights with a borrower's creditworthiness as indicated by the borrower's external credit rating. Unlike Basel 1A, banks using the standardized approach would have to assess operational risks. ICBA believes that the use of the standardized approach by the Basel II banks would reduce the impact on risk-based capital by those banks and would mitigate to some extent, the competitive disparity between Basel I and II.

ICBA Recommends A Study in 2008 Comparing Basel II and Basel IA; Basel II Should be Revised If Significant Differences Persist

During 2008—the year of the parallel run--ICBA recommends that the agencies conduct another study using data obtained from the Basel II and non-Basel II banks to determine the impact that a revised Basel I would have on minimum risk-based capital and whether the competitive disparities between the Basel I and Basel II accords would be mitigated by a Basel IA. If the new competitive impact study indicates continuing competitive disparities between Basel II and Basel IA similar to the results of QIS3, QIS4 and the FDIC staff study, then the three-year transition period should be put on hold until the regulators fundamentally revise Basel II. A fundamental revision of Basel II should include a consideration of whether other methods other than the IRB approach for credit risks and the AMA approach for operational risks should be used. **If Basel II cannot be revised to eliminate the competitive disparities, then the regulators should require that all banks either use Basel IA or Basel I.**

Conclusion

ICBA commends the banking agencies for proposing to retain the tier 1 leverage ratio as part of Basel II. ICBA strongly believes that the retention of the leverage ratio is essential to maintaining the safety and soundness of our banking system and is a needed complement to the risk-sensitive Basel II framework that is based only on internal bank inputs and risk parameters.

ICBA also commends the banking agencies for proposing to adopt transitional floors as well as committing to significantly modify Basel II if, during the three-year transition period, there is a 10% or greater decline in aggregate minimum risk-based capital of the Basel II banks as compared to minimum required risk-based capital as determined under the existing Basel I rules. ICBA believes that any change 10% or greater should warrant a fundamental change to the Basel II rules.

We agree that the agencies should never consider putting our entire banking system in jeopardy because a few banks claim that they need lower capital requirements to compete internationally**.** ICBA believes that capital standards are too important to leave to the Pillar II supervisory standards of Basel II and believes that the Basel II banks should continue to be subject to the Tier 1 leverage ratio requirement and the 10% tripwire after the Basel II transitional period ends even if there are different capital requirements between foreign and domestic banks.

To reduce the costs and complexity of Basel II, to enhance its flexibility, and to mitigate competitive disparities between the Basel II and Basel I banks,

ICBA supports allowing the Basel II banks the option of using the "standardized approach" of the new accord in lieu of the advanced IRB approach.

Even with Basel IA, the incorporation of transitional safeguards, and the leverage ratio, ICBA still remains concerned about the competitive effect of Basel II and recommends that the agencies conduct an impact study during 2008 to determine if there are still competitive disparities between Basel II and Basel IA. If the new competitive impact study indicates continuing significant differences in minimum risk-based capital between Basel II and Basel IA, then the three-year transition period should be put on hold until the regulators fundamentally revise Basel II.

ICBA appreciates the opportunity to generally comment on the Basel II NPR. If you have any questions about our letter, please do not hesitate to call me at 202-659-8111 or at Chris.Cole@icba.org.

Sincerely,

Christopher Cole

Regulatory Counsel