March 26, 2007

Office of the Comptroller of the Currency
Attn: Public Information Room
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
OCC Docket Number 06-09

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

Jennifer J. Johnson
Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket Number R-1261

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

Dear Sir or Madam:

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Notice of Proposed Rulemaking implementing Risk-Based Capital Standards: Advanced Capital Adequacy Framework (commonly referred to as Basel II).

Not surprisingly, the proposal to revamp the capital framework in the United States has resulted in a wide-ranging public debate. Even though only a small number of institutions will be required to adopt Basel II's capital framework, the ramifications for the entire financial system will undoubtedly be very significant. And while state regulatory agencies directly supervise only a portion of the Basel II core banks, CSBS is concerned about the possible systemic implications of implementing the Basel II framework without due consideration and full understanding of the framework's impact.

International Competition

An area that has received considerable attention is the possible impact Basel II could have upon the international competitiveness of U.S. banks. Industry representatives have vocalized their opposition to adopting Basel II with certain safeguards (specifically, the maintenance of the current leverage ratio, the trigger of regulatory changes if a 10 percent or greater drop in aggregate capital occurs among the group of core institutions, and the transition period consisting of a one-year parallel run and three-year implementation period). These industry representatives are concerned with their ability to compete with international institutions subject to a Basel II framework that does not require the above safeguards and other conservative aspects of the U.S. proposal.

CSBS adamantly supports the inclusion of the safeguards in the Basel II framework. The safeguards are necessary to ensure adequate capital remains in the system, and any unforeseen effects of Basel II's implementation can be countered and corrected. In addition, CSBS disagrees that the largest U.S. institutions will be placed at a competitive disadvantage as a result of the safeguards. The U.S. currently has high capital standards and maintains a fiercely competitive system. According to *The Banker*, of the top 1,000 banks in the world (ranked by tier 1 capital), 215 are U.S. institutions – the most of any country. As detailed in Exhibit A, U.S. banks maintain the highest tier 1 leverage capital ratios and generate the highest average return on equity. Under what relevant measurement are U.S. banks not competitive? Why does the U.S. need to lower capital standards to ensure U.S. banks can compete? CSBS believes it is because of our historically high capital requirements, not in spite of them, that U.S. institutions have thrived in international markets.

Strong capital is necessary for an institution to compete over the long-term and endure economic cycles. The capital levels of U.S. institutions have resulted in unassailable safety and soundness standards. These standards have attracted capital investments worldwide because investors are confident in the strength and consistency of the U.S. system. Therefore, CSBS supports FDIC Chairman Bair's call for an international leverage ratio. The leverage ratio is a necessary element to maintain and improve the safety and soundness in the global financial system. CSBS believes this reasonable, minimal standard for capital should have the full support of banking regulators, U.S. financial institutions, and the Congress.

Industry representatives have argued the leverage ratio will set the U.S. implementation of Basel II at odds with the international standard other nations will adopt. In truth, however, there is no real, international standard Basel II framework that will be adopted. Most countries have tailored the framework for their own, unique market. Several nations have blended the "advanced" and "standardized" approaches originally put forth by the Basel Committee.

U.S. financial institutions are among the most successful and competitive in the world. CSBS believes maintenance of high capital standards is a substantial contributing factor to the success enjoyed by U.S. institutions. CSBS does not believe the capital levels required by the leverage ratio will hinder the core banks internationally. In fact, implementing a Basel II framework without the safeguards, specifically the leverage ratio, would be detrimental to the core Basel II banks and to the U.S. financial system as a whole.

Domestic Competition

While maintaining the international competitiveness of our largest institutions is an important goal, our first priority as regulators must be the competitiveness between and among domestic banks operating in the United States.

If and when the Basel II capital framework is implemented, it will mark the first time that the U.S. has had different capital rules for different institutions. Before we implement multiple capital rules for U.S. institutions, it is vital to understand the impact of imposing separate capital frameworks. For example, what will the impact be upon the pricing of financial products such as residential mortgage loans, commercial real estate loans, or small business loans? Also, how would risk shift within the system as Basel II makes market decisions based upon the capital treatment generated by models? These and other questions must be suitably considered before the implementation of multiple capital frameworks.

An additional concern is the increased opportunity for capital arbitrage if the Basel II framework is implemented. The Basel II NPR could lead to increased consolidation by disrupting the normally functioning merger and acquisition market, with thinly capitalized banks receiving an incentive to acquire banks with larger capital. If the acquisition of community banks is accelerated by capital regulations, CSBS is concerned about the status of the tailor-made, small business loans underwritten by community banks, which may not receive favorable risk-based capital treatment under the Basel II models. It is possible these loans, which power small business in the U.S. and fuel the economy as a whole, will become much more difficult to obtain, and likely more expensive.

It is absolutely necessary that implementation of the Basel II framework does not adversely affect the financial system in the U.S. by putting smaller, non-Basel II banks at a competitive disadvantage with the core Basel II banks. The diversity of financial institutions in the U.S. banking system has contributed to our economic success. We need a strong community banking component. A modernization of the capital rules should not tip the balance too far in favor of one type of institution over the other.

Safeguards

Therefore, CSBS fully supports the safeguards as a responsible and reasonable protection of our banking system. The indefinite maintenance of a capital leverage ratio will provide consistency and stability to the system as a whole. The transition thresholds will help institutions gradually and safely convert to the Basel II framework. And despite all of our best efforts as regulators, implementing such a drastic change will undoubtedly have unforeseen repercussions. The trigger of regulatory actions if a 10% drop in aggregate capital among the Basel II core banks occurs allows regulators, institutions, and the public the opportunity to analyze the cause, effect, and potential consequences of a significant decline in capital.

The maintenance of a permanent leverage ratio is unquestionably the most vital of the safeguards. Without the leverage ratio, we will effectively be placing the Federal government as a lender of last resort, with a "too big to fail" mentality. Other nations may support free integration of the government with the banking industry. The United States, however, has never adopted this model.

Financial institutions should fuel the economy, not drag it down. Obviously, the failure of an internationally active or nationwide bank would shake the system and have severe ramifications. Conversely, the failure of a small bank or a community bank may not have much effect on the banking system as a whole, but the role a small bank plays in its local economy cannot be overestimated. A small bank failure would greatly disrupt the local community it serves. It is in all of our best interests as bank regulators to ensure that banks, large and small, remain competitive, manage their risks, and maintain adequate levels of capital.

Standardized Approach

Despite the concerns CSBS has regarding the implementation of the Basel II framework, we recognize the need for enhanced risk sensitivity for complex and internationally active institutions. In addition to the Basel II Advanced Approaches, the Standardized Approach, a logical, more transparent approach, deserves development in the U.S. The Standardized Approach would appeal to a broader number of institutions, which would alleviate some of the domestic competitive concerns CSBS currently harbors. Observations about the inclusion of an operational risk charge in the Standardized Approach can be addressed through education, quantification, and consideration of limits. Ultimately, CSBS believes the Standardized Approach is a balanced, risk sensitive approach and can serve as a transition piece to a more advanced framework.

Thank you for allowing CSBS to comment on this very important interagency proposal. With the passage of the Regulatory Relief Act, the chairman of the State Liaison Committee was made a voting member of the Federal Financial Institutions Examination Council (FFIEC). And although the Basel II NPR was developed and issued before SLC involvement, the states very much look forward to working with the federal financial agencies on future development of regulatory policy.

Best regards,

Neil Milner

Neil Milner, CAE
President & CEO

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Exhibit A

Bank Capital & Performance by Country

Top 1000 Banks by Tier One Capital

		Banks Removed from Sampling		Tier 1 Capital			Return on Equity		
Country	Banks in 1000	Leverage Ratio > 20%	Return on Equity < 0%	Average	Median	Affect on Average from Sampling Change	Average	Median	Affect on Average from Sampling Change
USA	215	5	3	8.34	8.05	-0.76	24.00	22.50	0.23
United Kingdom	32	4	2	7.18	6.01	-4.59	18.88	15.45	3.30
Switzerland	35	0	0	8.33	7.67	0.00	12.71	11.50	0.00
Spain	46	1	0	6.35	5.98	-0.30	17.48	16.75	-0.30
Japan	95	0	4	4.58	4.48	0.05	12.04	10.50	1.04
Italy	37	0	0	6.24	5.26	0.00	19.31	18.20	0.00
Germany	80	0	2	4.62	4.41	0.07	11.35	9.55	0.49
France	10	1	0	5.28	4.39	-8.36	20.76	18.05	1.78
Canada	11	0	0	5.00	4.23	0.00	20.94	23.30	0.00

Source: The Banker, July 2006