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December 30, 2003

Basel Committee on Banking Supervision
Bank for International Settlements
CH – 4002, Basel
Switzerland
BCBS.Capital@bis.org

Basel 2003 Capital Proposal
Office of the Comptroller of the Currency
Mail Stop 3-6
250 E Street, S.W.
Washington, D.C. 20219
Basel.Comments@occ.treas.gov

Basel Capital Proposal
Board of Governors of the Federal Reserve System
Mail stop 155
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551
Regs.comments@federalreserve.gov

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Comments@fdic.gov

Re: Basel Committee on Banking Supervision Revised Treatment of Expected Losses under the Proposed New Basel Capital Accord; October 11, 2003

Ladies and Gentlemen:

On October 11, 2003, the Basel Committee on Banking Supervision (BCBS) issued an announcement revising the treatment of Expected Losses (EL) under the proposed New Basel Capital Accord (New Accord). The American Bankers Association[1] (ABA) in its July 31, 2003, comments to the BCBS on the Consultative Paper No. 3 (CP3) had strongly criticized the CP3's treatment of Expected Losses and urged that the BCBS remove Expected Losses from the IRB approach to Unexpected Losses (UL) in the New Accord. The new treatment of Expected Losses will require banks to compare the IRB measurement of expected losses with the total amount of provisions that they have made, including both general and specific provisions. For any individual bank, this comparison will produce a "shortfall" if the expected loss amount exceeds the total provision amount, or an "excess" if the total provision amount exceeds the expected loss amount.

[1] The American Bankers Association brings together all elements of the American banking community to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks – makes ABA the largest banking trade association in the United States.

ABA supports the proposed new treatment of Expected Losses in principle, but notes that a final analysis of the new treatment awaits a thorough recalibration of the entire New Accord.

As we stated in our CP3 comment letter, we believe that setting regulatory capital only on Unexpected Losses is more theoretically sound than the previously proposed treatment where Expected Losses were included in regulatory capital calculations. The proposed new treatment of EL, which separates it from the treatment of UL for calculation of regulatory capital, appears to us to better correspond to how our banks treat these losses internally in their economic capital models. We believe that this is more consistent with the goal of using internal credit risk models for the assessment of adequacy of regulatory capital. However, our bankers tell us that significant recalibration of the CP3 proposal is needed to recognize that only unexpected losses are be reflected in risk-weighted assets. Thus, while we support the EL/UL proposal in principle, final support must await further information and text from the BCBS, including all of the adjustments to the calibration of the New Accord.

In addition to our need to see the BCBS's recalibration of the New Accord to determine if the proposed new treatment of EL achieves the improvement that it promises, we note already some concerns about the proposed new treatment. First, the BCBS's announcement suggests that any excess provisions, specific and general, over EL should be eligible for Tier 2 capital, with a 20% limitation. However, the announcement requires that any shortfall is deducted 50% from Tier 1 and 50% from Tier 2. We believe that this asymmetrical capital treatment of shortfall or surplus in reserves is inappropriate. We prefer that excesses of reserves over modeled EL should be eligible as capital without restriction as to amount, as we urged in our CP3 comment letter, and these excesses should be included in Tier 1 and Tier 2 in the same proportion that shortfalls would be deducted.[2]

Finally, we continue to urge that our regulators work with the appropriate accounting policy entities to ensure that accounting treatment of reserves aligns with the regulatory treatment. For example, in the U.S., the American Institute of Certified Public Accountants (AICPA) has issued an exposure draft of a proposed Statement of Position (SOP), Allowance for Credit Losses that proposes a new, more restrictive treatment of unallocated reserves. These interpretations could significantly alter reserving practices of banks with respect to unallocated reserves - to the point that the U.S. regulators sent a strong letter to the AICPA on October 6,2003, urging that the AICPA abandon its proposal: "In addition to being fundamentally flawed, the proposed SOP is not clearly written, which no doubt has contributed to its pervasive misinterpretation throughout the financial community. AcSEC should abandon this effort and move forward with a final SOP that is limited to improving disclosures related to credit risk and loan loss allowances." Coordination by the BCBS with international accounting entities to achieve such an alignment is imperative.

Sincerely,

Paul Smith
Senior Counsel

Robert Strand
Senior Economist

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[2] We had previously recommended that "All of the reserves should be recognized as regulatory capital. One hundred percent of loan loss reserves should count as Tier 1 capital rather than just counting as Tier 2 capital." However, given that the new treatment would deduct shortfalls in this proportion, it makes sense to us to include excess in the same proportions.