Comments by rating-agency bank analysts on the proposed Basel II risk-based capital standards issued jointly by the Board and the other bank regulatory agencies.

On April 5,2005, rating-agency bank analysts from Standard and Poor's, Fitch Ratings, and Moody's, all in New York, New York, met with members of the Board to discuss, among other issues, risk management and Basel II. Kim Olson, Managing Director, Fitch Ratings, led the presentation of views on whether banks' decisions to opt in to Basel II will affect their credit rating, whether investors will penalize large banks that do not opt in, and whether regional banks will feel similar market pressures to opt in.

Fitch stated that the public disclosure component (Pillar 3) of the Basel Capital Accord is raising investor expectations on disclosure and transparency. Although Basel II is an improved yardstick of capital relative to underlying risk, it is still challenging for investors to pierce through a bank's risk profile. Proper interpretation of Basel II risk disclosures will require the release of additional information on topics such as credit concentrations and the bank's approach to managing its capital position over the economic cycle. A premium will be placed on credit analysis that can compare risk in a systematic way across banks.

Fitch indicated that Basel II would (i) enhance bank risk management practices; (ii) introduce a common language around risk management (for example, probability of default, loss given default, and expected loss); (iii) sharpen bank-investor discussions of capital and risk management; and (iv) provide better bank disclosure of capital levels and risk profile.

Banks that opt in to Basel II are likely to range from the $250 billion "mandatory" threshold downward to about $50 billion. The larger banks are more likely to opt in, but as the size of the bank moves down the range, the bank's decision to opt in is less clear. The decision on whether to opt in likely will center on the costs and benefits of adopting Basel II. Potential benefits to the banks might include the perception by the market that they are sophisticated risk managers, the banks' ability to demonstrate how their capital allocation practices and risk profiles compare to those of their peers, and potential regulatory capital benefits on certain types of credits.

Fitch listed several potential drawbacks of opting in. The costs of implementing Basel II systems are high, especially on lower scale areas or less material portfolios. In addition, there is the view that Basel II capital requirements will not necessarily affect a bank's capital strategy. Smaller banks still will be likely to "top off' capital levels to account for the following matters: (1) less geographic, product, and asset diversification (Basel II calibration assumes a well-diversified portfolio); (2) less access to capital markets and less ability to shed risk dynamically; and (3) weathering potential downturns in the cycle. The market likely will expect a healthy capital buffer over Basel II capital requirements for smaller banks for these same reasons.

Fitch believes that investors are likely to be sensitive to the need for cost/benefit analyses by banks. There is a sentiment that investments in fully compliant Basel II systems must add value to the bank. Fitch will continue to evaluate the quality of a bank's risk management systems relative to its risk profile and scale of operations. The agency believes that it is not necessary for every bank to be Basel II compliant. That decision should be made on a case-by-case basis. Nevertheless, there is value for non-Basel II banks in leveraging certain Basel II measurement tools. Fitch's ratings process will continue to take a multifaceted view of a bank's capitalization beyond its choice of regulatory approach. Further, there is a need for banks to respond intelligently to shareholders and creditors about the bank's Basel II decision. The response should demonstrate sufficient knowledge about Basel II and should inform investors of the impact Basel II likely would have on the bank.

Fitch believes that banks that opt in to Basel II should have a good grasp of the associated costs and the potential benefits. If adoption of Basel II by a particular bank cannot be justified economically, then investors are not likely to demand adoption by that bank. Fitch believes that Basel II's diversification assumption creates a high hurdle. Regional banks with heavily concentrated portfolios are likely to need to "top off' capital, making official adoption of Basel II less beneficial for them.

Moody's and Standard and Poor's stated that they, too, would not pressure institutions to opt in. They agreed with Fitch that implementation costs would be a burden for smaller institutions. Fitch said they would encourage smaller banks to look at the underlying methods behind Basel II and potentially to use some of them for internal risk management and capital allocation. Fitch would also look for increased risk disclosure even from those institutions that do not opt in. They would not encourage banks to decrease their capital even if Basel II were to leave them with lower regulatory capital requirements. Moody's said that simply enhancing internal credit-rating systems and monitoring their performance over time would provide useful risk management information to smaller institutions. They encourage banks to look at how they would alter their current risk management approach and the changes they would have to make to opt in. Standard and Poor's stated that the better risk management tools and processes needed to implement Basel II were desirable and that the key step needed now is to develop databases of loss events.