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April 14, 2005

The Honorable Alan Greenspan
Chairman
Board of Governors of the
Federal Reserve System
20th and Constitution Ave., NW
Washington, D.C. 20551

The Honorable Donald E. Powell
Chairman
Federal Deposit Insurance Corporation
550 – 17th Street, NW
Washington, D.C. 20429-9990

The Honorable James E. Gilleran
Director
Office of Thrift Supervision
1700 G Street, NW
Washington, D.C. 20552

The Honorable Julie L. Williams
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
Independence Square, 250 E Street, SW
Washington, D.C. 20219-0001

Dear Sir or Madam:

On January 27, the federal banking agencies announced their commitment to review the existing risk-based capital requirements and to institute appropriate revisions by the time the Basel II rules go into effect in 2008. The American Bankers Association has requested just such a reassessment since the beginning of the Basel II deliberations, so we welcome this pledge. While the banking industry is generally supportive of the Basel II improvements, this new standard is likely to lead to significant competitive advantages for the large banking firms that adopt them. To maintain competitive balance within the industry, an appropriate update of the capital rule for the other approximately 7,800 banking firms is called for.

As you know, the original Basel Accord was developed more than fifteen years ago to provide a uniform international regulatory standard specifically for large, internationally active banks. The U.S. banking regulators, however, elected to apply it to every bank in this country. The generic model never fit the wide variety of individual circumstances of American banks well, particularly the smaller institutions. Customization, we were told, was out of the question, since the rule was developed through international collaboration. With multinational adoption of Basel II, the existing risk-based capital standard will become something of an archaic, idiosyncratic U.S. standard. In profound irony, it will be applied chiefly to the banks for which it was not intended, those that are not in the ranks of the largest or internationally active institutions. This mismatch of capital standards needs to be addressed.

Once Basel II goes into effect and is adopted by the ten-to-twenty largest banking firms, there are likely to be significant competitive disparities within the industry. Evidence from the Quantitative Impact Studies indicates that adopting institutions will have significantly lower risk-based capital requirements for good credits, even after accounting for operational and other risks under Basel II. An adopter will be able to make the same loan as a community or regional bank, but at a fraction of the risk-based capital assessment. The effect will be that the large adopting institutions will have additional capital resources that they can use to compete with, or perhaps even buy up, smaller banks, artificially stimulating industry concentration.

Your analysis should not ignore the growing competition from non-bank financial service providers. Banks now contend with numerous financial and even commercial firms that are not subject to regulatory capital standards. As examples, GMAC offers consumer loans and home mortgages, and real estate brokers Century 21, Coldwell Banker and Long & Foster provide home mortgages and title and property insurance.

In reconsidering the risk-based capital rule, we request that you give special attention to home mortgages, commercial real estate loans, externally-ratable small business loans, and retail credits (supported by appropriate default and loss data). Additional, lower-weighted buckets should be provided for demonstrably good credits in these categories. For residential and commercial mortgages, an unprecedented combination of tax changes and supervisory problems in the 1980s – conditions unlikely to be repeated – made charge-off rates much higher when the risk-weights were originally set than now; substantially lower risk-weights are justified today. Similarly, we request that you consider increased recognition of collateral and other risk mitigants than is provided for in the current rule. We would also suggest that you consider acceptance of intangibles, such as those for core deposits, in the capital numerator of the risk-based capital formula.

Officials from the Federal Reserve and Office of Thrift Supervision have recently indicated the possibility of reviewing the leverage ratio for the banks that adopt Basel II. Inasmuch as this is reviewed for adopting banks, we believe that competitiveness concerns would call for corresponding action for non-adopting banks.

We appreciate your concerns for all the community and regional banks for which Basel II is unjustifiably expensive and complex. We look forward to the forthcoming Advance Notice of Proposed Rulemaking to start the process of revising the risk-based capital standard for non-adopting banks to promote the competitiveness of the entire banking industry. Public review of revisions to the risk-based capital standard for non-adopting banks concurrently with the public comment on the Basel II regulations would facilitate valuable comparisons and enhance the likelihood that competitive inequities can be detected and addressed.

The depth and breadth of the banking industry in America is one of the crown jewels of our financial system, providing benefits to bank customers that are unavailable anywhere else in the world. We appreciate your care in the important review of capital standards so as not only to preserve but to promote these benefits.

Sincerely,

James D. McLaughlin