



January 24, 2005

Office of the Comptroller of the Currency
250 E Street, S.W.
Public Information Room
Mailstop 1-5
Washington, DC 20219

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Attention Docket No. 04-22
regs.comments@occ.treas.gov

Attention: Docket No. OP-1215
regs.comments@federalreserve.gov

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

comments@FDIC.gov

Attention: No. 2004-48
regs.comments@ots.treas.gov

Re: Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital
69 FR 62747 (Oct. 27, 2004)

Dear Mesdames and Sirs:

America's Community Bankers ("ACB")¹ is pleased to comment on the proposed Supervisory Guidance on Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital.² The guidance outlines U.S. bank regulatory expectations for banking organizations that will adopt the advanced internal ratings-based ("IRB") approach to capital outlined in the recently finalized *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* ("Basel II").

In June 2003, the U.S. banking regulators issued an Advance Notice of Proposed Rulemaking to begin implementation for Basel II in the United States ("ANPR").³ The proposal formally set

¹ America's Community Bankers is the member-driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit www.AmericasCommunityBankers.com.

² 69 Fed. Reg. 62747 (Oct. 27, 2004).

³ 68 Fed. Reg. 45900 (Aug. 4, 2003)

forth the U.S. regulator's position that Basel II would apply only to the 10 to 12 largest U.S. banking organizations that have total assets of \$250 billion or more or total on-balance sheet foreign exposure of \$10 billion or more. Other institutions would have the opportunity to opt-in to Basel II if they can meet very strict and burdensome eligibility standards. The proposed supervisory guidance outlines the eligibility standards that would have to be met in the retail credit area.

ACB Position

The complexity of the proposed supervisory guidance confirms our earlier view that adoption of Basel II by community banks will not be a viable option. We made this point in our comment letter on the ANPR and we continue to believe that is the case. We are pleased that the regulatory agencies have committed to review Basel I and make appropriate revisions within the same time frame as implementation of Basel II. Allowing more institutions to benefit from more risk-sensitive capital requirements will increase the safety and soundness of the banking system by providing incentives to a greater number of institutions to improve their risk management systems. Also, appropriate revisions to Basel I will help mitigate the adverse competitive impact we believe will accompany implementation of Basel II. We do not believe that Basel II should be implemented until appropriate revisions are made to Basel I.

The complexity of the guidance also underscores questions we had in our ANPR comment letter with regard to the ability of institutions to understand and implement and of supervisors to adequately administer and enforce minimum capital requirements of Basel II. This is reinforced by the fact that the guidance contained an error in a critical formula that was not corrected until more than two months into the comment period. If institutions followed the formula as it appeared in the guidance, required capital requirements for retail loans could have been significantly understated. It is not surprising that errors may appear during both the implementation and supervision of Basel II. This highlights the need to investigate the real world consequences of adopting an extremely complicated capital regime, including the resources needed for implementation, the problems inherent in on-going maintenance, and the probability of effective regulation and market oversight.

We have serious concern about the language in paragraph 241 of the guidance addressing the role of the external auditor. The language is very broad and appears to require an institution's external auditor to confirm the integrity and accuracy of the institution's IRB system. This requirement is outside the scope of an auditor's responsibility and there are no applicable auditing and professional standards that would guide such a review. Additionally, this would be an impractical use of the auditor's expertise and the associated audit fee increases would be unjustified.

In the aftermath of recent corporate scandals and the passage of the Sarbanes-Oxley Act of 2002, public auditors are reading their responsibilities quite broadly under corporate governance regulations to ensure that they do not run afoul of requirements imposed by the Public Company Accounting Oversight Board and bank regulators. While this is not surprising and it is easy to

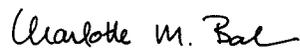
sympathize with the auditor's concerns about doing the right thing, it is placing a heavy burden on companies both in terms of cost and disruption to normal business operations.

We believe the language in paragraph 241 should be deleted to avoid an incorrect interpretation of the responsibilities of external auditors with regard to IRB systems. The responsibility of ensuring the integrity of an IRB system and evaluating compliance with Basel II and supervisory guidance should be the job of bank supervisors. Identification of external auditor responsibilities and duties should be left to the authorities that establish auditing standards.

We would encourage the regulators to reconsider the treatment of "unseasoned loans" in Paragraph 100. It is our understanding that requiring use of a probability of default ("PD") that reflects an average annualized cumulative default rate over remaining life rather than a long-run average of one-year PD's does not conform to best practices and may have perverse results with regard to the retention of loans in a portfolio.

ACB appreciates the opportunity to comment on this important matter. If you have any questions, please contact the undersigned at (202) 857-3121 or via e-mail at cbahin@acbankers.org, or Diane Koonjy at (202) 857-3144 or via e-mail at dkoonjy@acbankers.org.

Sincerely,



Charlotte M. Bahin
Senior Vice President, Regulatory Affairs