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United States Senate

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November 3, 2003

COMMITTEES:
FINANCE

BANKING, HOUSING, AND URBAN AFFAIRS

CLO: #G - 98
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RECVD: 11/4/03
BS+R

cc: S. Alvares
E. Elton

The Honorable Alan Greenspan
Chairman
Federal Reserve Board of Governors
20th St & Constitution Ave NW
Washington, DC 20551

The Honorable John Hawke
Comptroller
Office of Comptroller of the Currency
Washington, DC 20219

The Honorable Donald Powell
Chairman
FDIC
550 17th St, NW
Washington, DC 20429

The Honorable James Gilleran
Director
Office of Thrift Supervision
1700 G St. NW
Washington, DC 20552

Dear Chairman Greenspan, Comptroller Hawke, Chairman Powell and Director Gilleran

I am writing on behalf of my constituents to voice my concern regarding your proposed implementation of the international capital accord called Basel II in your Advanced Notice of Proposed Rulemaking (ANPR).

I am in favor of an updated agreement on capital standards that would better align risk with capital while ensuring the safety and soundness of our financial system. However, it has come to my attention that the Accord, as currently proposed, would impose significant and unwarranted costs on U.S. banks, undermining their international competitiveness without any benefit in reduced risk.

Presumably, the goal of the ANPR and other prudential financial regulation is to protect against risk without infringing on the ability of financial institutions to perform their functions as efficiently and economically as possible, and also to protect against the possibility that the form in which regulation is adopted could have negative consequences on some institutions vis-à-vis others. With this in mind, it would seem that the approach taken on the proposed standard concerning operational risk is a misguided one. I realize that the ANPR attempts to address problems with the new Accord's operational risk-based capital charge by only applying the advanced measurement approach in the U.S. Nevertheless, any approach by U.S. regulators that imposes an operational risk-based capital charge on banks is fundamentally flawed.

Due in large part to your continued efforts, the U.S. banking industry's regulatory capital and supervisory framework is among the most robust in the world. I recognize the need for depository institutions to allocate capital for some risks. However, I take seriously the concerns of those who contend that a capital charge for operational risk is unwarranted

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and arbitrary. I am informed that no U.S. bank has ever failed due to operational risk and I have yet to hear compelling evidence that a capital charge for operational risk would reduce it or improve risk management practices. Indeed, it seems to me that a capital charge for operational risk would actually create a perverse incentive against costly operational risk mitigation, thereby increasing both institutional and systemic risk. After September 11, it was clear that contingency planning and disaster recovery were essential to the rapid resumption of essential financial services and the avoidance of systemic risk. I would therefore prefer to see banks devote their financial resources to make certain that systems and procedures are in place to monitor and prevent this risk rather than to meet the requirements of an unnecessary capital charge.

Additionally, this capital charge would likely have the unintended impact of undermining the competitiveness of many U.S. banks. I understand that the EU can impose this proposal on banks and non-banks, but that is not the case in the U.S. Therefore, I have serious concerns about what potential impact this capital charge would have on specialized banks whose core businesses may be asset management and/or payment processing, where non-bank competitors are very large. We should explore the question of how we avoid pricing distinctions between two equally well-run institutions, and whether or not we are providing some incentive for people to change the nature of their charters because of the impact that Basel II may have. Moreover, it is also important to consider what the systemic implications would be if one or more U.S. banks changed their charter to avoid the operational risk-based capital charge in order to preserve their competitiveness.

Furthermore, another particularly troubling aspect of the operational risk-based capital charge is the fact that U.S. banks would have to hold capital for risk associated with compliance with U.S. laws and regulations regarding employment or loan discrimination, as well as those associated with our class-action litigation system. I see no reason to impose a capital charge for these legal risks, which have never played a role in the failure of any U.S. bank, and which are generally exclusive to the U.S. Doing so will further exacerbate the competitive impact of this flawed rule on our banking institutions.

Based on the concerns outlined above, I urge you to refrain from implementing any revisions to the Basel Accord that include a specific regulatory capital charge for operational risk.

Sincerely,

A handwritten signature in black ink that reads "Rick Santorum". The signature is written in a cursive, flowing style with a large initial "R".

Rick Santorum
United States Senate