Heidi Miller
Executive Vice President
Email: Heidi_Miller@bankone.com

Office of the Chief Financial Officer
Mail Code IL1-0334
One Bank One Plaza – 9th Floor
Chicago, IL 60670

tel (312) 336-3060
fax (312) 336-2350

BANK ONE.

November 3, 2003

Office of the Comptroller of the Currency
250 E Street SW
Public Information Room, Mailstop 1-5
Washington, DC 20219
Attn: Docket No. 03-15

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

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2003-28

Robert E. Feldman
Executive Secretary
Attention: Comments,
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Ladies and Gentlemen:

Bank One Corporation is pleased to offer comment on the interagency document - 'Advance Notice of Proposed Rulemaking' (ANPR) - outlining the proposed implementation of the new Basel Capital Accord in the United States. Our response highlights specific areas within the proposal that differ from industry best practice. Primary issues of concern center on Pillar I calibration, the securitization framework, operational risk and disclosure requirements.

We understand the need to balance the complexity required for better risk differentiation with the simplicity required to ensure consistent implementation. As such, we offer practical alternatives that provide a framework more consistent with industry practice without sacrificing the spirit of the proposal. Finally, an appendix contains more detailed responses to some of the questions raised within the ANPR that are most important to Bank One.

True Minimum Standard

Note: We agree with the recently reported change to the Basel framework that excludes expected loss from capital requirements. Presumably the modification will reduce risk-weighted assets by 12.5 times expected loss. In addition, reserve adequacy should be based on

<u>one year</u> expected loss to capture the fact reserves are replenished over time through margin income and will become available to cover expected losses beyond one year.

The fundamental premise of Pillar I is that it should establish a true minimum capital standard (i.e., represent the lowest solvency standard tolerable for regulated firms), relying on Pillars II and III to motivate firms to operate at an appropriate level of capitalization. There are numerous instances in the proposal where minimums and limits introduce a degree of conservatism to the capital calculation. These include limited recognition of risk mitigation tools, limited recognition of collateral on certain loans, and minimum risk weights for certain assets. The cumulative effect of this conservatism produces a capital standard well above a true minimum.

Proper calibration of the risk weight functions is critical to a regulatory framework in order to avoid non-economic incentives or barriers to fair competition. Current calibration results in regulatory capital requirements that exceed Bank One's internal estimates of economic capital for certain assets. The root cause appears to be the adoption of pre-defined asset value correlation (AVC) for each asset type on the balance sheet. The discrepancy arises from the assumed relationship between probability of default (PD) and AVC embedded in the risk weight function. While we accept that low risk borrowers typically hold larger, more diversified asset portfolios leading to higher AVC, analysis of our retail and commercial data has not produced the magnitude of the inverse relationship the risk weight formulas suggest. A more accurate level of capital would result from using an institution's internal estimate of AVC and volatility as inputs to a single risk weight function.

The following three examples illustrate our calibration concerns:

> <u>Prime Credit Card Assets</u> – (*regulatory requirements exceed economic capital estimates*) - The loss volatility in our prime credit card portfolio data is too low to support the level of capital resulting under the proposal. This is particularly true for highest quality exposures, which represents the majority of our portfolio. Our credit card data stressed to three times its observed volatility fails to produce economic capital factors as high as those implied by the risk weight function. Quantifying the difference, credit card assets with PD less than five percent attract economic capital between one and three percent using the stressed Bank One loss volatility, where the proposal indicates regulatory capital requirements of more than five percent.
>
> <u>Second Lien Home Equity Loans</u> – (*asset type directed to wrong risk weight function*) - The residential mortgage curve is calibrated for traditional first mortgages rather than high combined loan-to-value (CLTV) second mortgages or home equity loans. Given the higher loss severity on these loans relative to traditional first mortgages, the mortgage risk weight function produces unusually high capital requirements. As a result, the capital requirement for a high CLTV second mortgage is greater than it is for an unsecured credit card loan to the same borrower.
>
> The mortgage risk weight function uses a constant 15% AVC across PD to capture the influence of housing values on losses. High CLTV second mortgages with very little collateral protection are much less susceptible to changes in the underlying housing value than traditional first mortgages. The highest CLTV second mortgages,

particularly those subordinate to high loan to value first mortgages, are effectively unsecured loans.

Analysis of internal data demonstrates that borrowers in the extreme circumstance of abandoning their residence rarely continue to pay their credit card bill. In other words, a mortgage is not subordinate to a credit card. As LTV increases and collateral protection goes away, capital requirements for a second mortgage should approach but never exceed the capital requirement for an unsecured credit card loan to the same borrower.

<u>Wholesale Lending</u> – (*regulatory requirements exceed economic capital estimates*) - The wholesale risk weight function produces capital requirements 25 to 50 percent higher than economic capital estimates for investment grade assets. This, too, is a result of the magnitude of the inverse relationship between PD and AVC assumed in the risk weight function. We have not found evidence to support this assumption for wholesale assets. Our analysis does show a statistically significant relationship between an obligor's sales volume and AVC, but little statistical significance to the relationship between sales volume and PD.

<u>Securitization – Multi-Seller CP Conduits</u>

Another recently announced change to the Basel II framework is the elimination of the supervisory formula approach for unrated securitization exposures funded through commercial paper conduits. With the elimination of the supervisory formula, we support a ratings based approach (RBA) using internally assigned ratings. Monitored under Pillar II, internal ratings will directly recognize credit enhancements provided by over-collateralization and other structural components resulting in a comprehensive view of the risk of the transaction. This will align regulatory capital requirements with industry risk measurement practices.

Internal ratings would be mapped to the RBA risk weight tables to determine capital, but the existing tables do not provide for low loss given default tranches such as the senior, very thick tranches generally present in conduit transactions. The existing tables also fail to recognize risk mitigation structures, which include asset quality tests that protect the liquidity bank from funding defaulted assets in the event of liquidity draw and 364-day renewable liquidity facilities that allow for annual re-evaluation and tightening of the structural features in the transaction when necessary. These risk mitigation tools significantly reduce the risk of a conduit transaction versus similarly rated transactions in the term ABS market. Supplementing the currently proposed risk weight table with an additional column and/or credit conversion factor would provide proper risk differentiation for these types of assets.

The original proposal included a separate evaluation of dilution risk. As internal ratings implicitly recognize all structural risks including dilution risk, it would be a double count to include a separate explicit analysis of dilution risk within an internal ratings based approach. Internal ratings capture not only exposure to dilution risk, but also the impact of the mitigating structural components such as recourse to the seller, reserves and over-collateralization.

Program wide credit enhancement provides umbrella coverage to multiple conduit securitizations and 'overlaps' coverage provided by deal specific liquidity facilities. As currently proposed, the regulatory capital requirement is established based on the riskiest of the overlapping pieces. Specifically, the proposal sets aggregate capital for the combined exposure based on the worst rated deal covered by the program wide credit enhancement. It would be more accurate to measure the capital requirement for the program wide credit enhancement against the weighted average risk of all assets covered under the protection. Using the rating of the worst quality asset leads to a large overstatement of capital requirements for some umbrella coverage and could discourage banks from investing in this mitigation tool.

Securitization – Revolving Assets

Previously we noted that the risk weight function for credit card assets produces capital requirements too high for the given risk. At the same time, the proposal to provide capital relief for credit card securitizations understates the risk retained by the originating firm. While the effect of the two may offset, individually they may drive non-economic decisions.

The treatment of revolving securitizations is inconsistent with the stated objective of providing capital relief only when meaningful risk transference occurs. This form of securitization functions primarily as a financing vehicle, which utilizes structural mechanisms to insulate the investor from the credit risk of the receivables in all but catastrophic events. The proposed framework for revolving structures creates a 'cliff effect' requiring increased capital as spread income deteriorates on the securitized pool of assets. This is the only place in Basel where capital is required as the capital event approaches and forces originators to raise capital when it becomes too expensive or is the least available.

Operational Risk

Bank One supports directly addressing operational risk within the regulatory framework. Implementation under the AMA guidelines is an important step towards a principles-based internal model approach. Nevertheless, it will be important to coordinate regulatory oversight with other governmental guidance such as FDICIA and Sarbanes-Oxley. The following points highlight our concerns with the current proposal:

> Definition of Capital – Removal of expected loss from the definition of capital should extend to operational risk capital as well. The connection between spread or other income and operational loss expense is less clear than it is for credit risk; however, banks budget, reserve and pay for expected operational losses through the normal course of business. As written, the proposal casts doubt on a bank's ability to demonstrate that EL is accounted for through reserves, operational costs and pricing.
>
> Analytic Limitations – The nature of operational risk data and the amount of data currently available limit the ability to objectively infer robust capital factors using purely statistical methods. Establishing meaningful event correlation and populating the 'tail' of operational loss distributions will require input beyond tangible loss data.

A standard of “substantiated judgment”, with Pillar II oversight, should enhance or replace direct statistical analysis.

Disclosure

We support the notion of market discipline through increased disclosure in conjunction with a true minimum regulatory capital standard established through Pillar I. However, we are concerned about potential competitive inequalities arising from the Pillar III requirements, as financial service companies falling under its governance will disclose information that other less regulated industries will not.

Given its complexity, the disclosure mandated by the proposal is not likely to benefit the majority of investors. As the markets have demonstrated an ability to drive increased transparency with minimal impetus from regulatory bodies, we advocate a market discipline that strikes an appropriate balance between the informational value of disclosure and the benefit of reduced capital.

Disclosure is appropriate only when industry consensus around definitions and measurement standards has been achieved. While the proposal provides recommended disclosure formats, it does not ensure comparability across institutions, as much of the underlying data is subjective in nature. The lack of comparability may lead to misinterpretation and make meaningful comparisons across firms difficult. This issue is already apparent in disclosures surrounding interest rate risk. We encourage the re-examination of the balance between supervisory oversight under Pillar II and market disclosure under Pillar III as one means to address these concerns. The appendix highlights several specific concerns regarding the Pillar III draft paper as currently written.

Conclusion

While we agree with recent changes announced regarding treatment of expected loss and the supervisory formula, we remain concerned about calibration of the minimum standard and certain details of the treatment of securitizations. The implementation detailed in the ANPR represents significant progress toward the common goal of establishing a more robust risk-based capital standard for the financial services industry. We are optimistic that the remaining issues can be resolved satisfactorily for the industry

Sincerely,

/s/ Heidi Miller
Heidi Miller
Executive Vice President and
Chief Financial Officer

BANK ONE CORPORATION
APPENDIX

General Framework

ANPR:

What are commenters' views on the relative pros and cons of a bifurcated regulatory framework versus a single regulatory framework? What are the competitive implications for community and mid-size regional banks?

If regulatory minimum capital requirements declined under the advanced approaches, would the dollar amount of capital these banking organizations hold also be expected to decline?

The Agencies seek comment on whether changes should be made to the existing general risk-based capital rules to enhance the risk-sensitivity or to reflect changes in the business lines or activities of banking organizations without imposing undue regulatory burden or complication. In particular, the Agencies seek comment on whether any changes to the general risk-based capital rules are necessary or warranted to address any competitive equity concerns associated with the bifurcated framework.

ONE:

We support the move to a more risk sensitive regulatory framework; however, we continue to view Pillar I as a true minimum capital standard. Whether an institution operates as an advanced bank or a non-advanced bank, their internally estimated economic capital should be higher than the Pillar I standard. Pillars II and III will function to drive banks to the appropriate capital levels.
Bank One understands the practical value of a bifurcated implementation of Basel II, however, there are potential issues with this varied approach. To avoid penalizing advanced banks, the proposal should not require a substantial amount of overhead for the sole purpose of meeting A-IRB requirements. Also, in many local markets where non-advanced banks are in price competition with advanced banks, there may be a competitive disadvantage that results from adverse market perceptions of being a "non-advanced" bank.

Bank One recommends that in a bifurcated framework, non-advanced banks use the new standardized approach for Pillar I. The standardized approach is more risk sensitive than the current regulatory framework and also includes explicit recognition of operational risks. Adopting the standardized approach will help move and encourage non-advanced banks in the direction of the advanced framework.

ANPR:

The Agencies are interested in comment on the extent to which alternative approaches to regulatory capital are implemented across national boundaries might create burdensome implementation costs for the US. subsidiaries of foreign banks.

ONE:

The home supervisor, rather than the host country's supervisor, should have jurisdiction over the regulatory capital rules for internationally active banks in order to minimize the number of regulations those banks must follow. In the event that the host supervisory is given jurisdiction for Basel implementation, using a standardized approach for assets under foreign jurisdiction should have no negative impact on our advanced status within the United States.

ANPR:

Given the general principle that the advanced approaches are expected to be implemented at the same time across all material portfolios, business lines, and geographic regions, to what degree should the Agencies be concerned that, for example, data may not be available for key portfolios, business lines, or regions? Is there a need for further transitional arrangements? Please be specific, including suggested durations for such transitions.

ONE:

Assuming there are no major changes to the structure of the framework, Bank One will meet the standard for becoming an IRB bank by the projected implementation date. Although the retail and operational risk frameworks are less developed, we do not foresee any issues regarding these areas that will prevent Bank One from meeting the deadline. Throughout the implementation process, Bank One will continue to engage in constructive dialogue with Supervisors as issues arise. Beyond the implementation date, we expect to continue to refine and enhance our analysis to ensure that our capital levels will be indicative of the most accurate assessment of risk available.

ANPR:

What are the advantages and disadvantages of the A-IRB approach relative to alternatives, including those that would allow greater flexibility to use internal models and those that would be more cautious in incorporating statistical techniques (such as greater use of credit ratings by external rating agencies)?

ONE:

It is difficult to capture accurately the full spectrum of risk across products and lines of business with only one wholesale and three retail risk weight functions. Calibration will help with the overall capital level, but regulatory requirements for some risk segments will be too high and others too low. A more accurate alternative is to allow advanced firms to provide their own estimates for asset value correlation and volatility. Advanced banks already produce parameter driven, risk sensitive economic capital requirements based on sophisticated internal models. Using asset value correlation assumptions in the regulatory framework is the next logical step to capital requirements fully based on internal models.

ANPR:

Should the A-IRB capital regime be based on a framework that allocates capital to EL plus UL, or to UL only? Which approach would more closely align the regulatory framework to the internal capital allocation techniques currently used by large institutions?

ONE:

We applaud Basel II's recent change excluding EL from capital, as it will help to align the Accord with industry practice. Given the removal of EL from capital, we agree with the adjustments to the treatment of FMI and reserves.

Wholesale Exposures

ANPR:

If the Agencies include a SME adjustment, are the $50 million threshold and the proposed approach to measurement of borrower size appropriate? What standards should be applied to the borrower size measurement (for example, frequency of measurement, use of size buckets rather than precise measurements)?

ONE:

A framework that includes internally estimated AVC as an input avoids the need for the $50 million threshold. We observe in our data a significant correlation between an obligor's sales size and AVC. This means that smaller firms have lower AVC and subsequently less capital directly achieving the objective intended by the threshold without resorting to arbitrary means. However, if the proposal uses a threshold to recognize the size effect, there should be a smooth transition across it (as in the current proposal) rather than a stair-step or on-off transition. The phase-in of the size benefit embedded in the current proposal minimizes the risk of gaming the formula.

ANPR:

The Agencies invite comment on the competitive impact of treating defined classes of CRE differently. What are commenters' views on an alternative approach where there is only one risk weight function for all CRE? If a single asset correlation treatment were considered, what would be the appropriate asset correlations to employ within a single risk-weight function applied to all CRE exposures?

ONE:

Given that a small percentage of commercial real estate loans will be considered HVCRE, Bank One is not in favor of lumping all commercial real estate together and subjecting this aggregated portfolio to a higher capital formula. However, Bank One welcomes the consolidation of commercial real estate exposure if such exposures could utilize the standard A-IRB formula. We propose that an acceptable approach to commercial real estate is to require that the LGD either incorporate the high correlation to PD or that a conservative approach to real estate values be used for the LGD factor.

Retail Exposures

ANPR:

The Agencies are interested in comment on whether the proposed $1 million threshold provides the appropriate dividing line between those SME exposures that banking organizations should be allowed to treat on a pooled basis under the retail A-IRB framework and those SME exposures that should be rated individually and treated under the wholesale A-IRB framework.

ONE:

Rather than a dollar amount threshold, regulatory treatment should be aligned with how these assets are underwritten and managed. Bank One underwrites small business loans both using credit scoring tools similar to consumer loans and incorporating judgmental underwriting similar to commercial loans. The proposal should provide banks the flexibility to decide which risk management method is appropriate for each asset.

ANPR:

The Agencies are seeking comment on the proposed definitions of the retail A-IRB exposure category and sub-categories. Do the proposed categories provide a reasonable balance between the need for differential treatment to achieve risk-sensitivity and the desire to avoid excessive complexity in the retail A-IRB framework?

ONE:

As noted previously, it is difficult to distill retail risk down to three risk weight functions. We would prefer a framework where AVC is a direct input to the capital formula. However, without directly addressing AVC, Bank One supports the possibility of adding exposure categories or sub-categories if the industry data suggests that there is indeed separation of asset value correlation between product groups. Calibrating the AVC curves for retail is essential towards deriving meaningful minimum capital requirements, since they will be the main driver of any differences between regulatory and internal economic capital factors.

ANPR:

The Agencies are interested in comments and specific proposals concerning methods for incorporating undrawn credit card lines that are consistent with the risk characteristics and loss and default histories of this line of business.

The Agencies are interested in further information on market practices in this regard, in particular the extent to which banking organizations remain exposed to risks associated with such accounts. More broadly, the Agencies recognize that undrawn credit card lines are significant in both of the contexts discussed above, and are particularly interested in views on the appropriate retail IRB treatment of such exposures.

ONE:

The risk of undrawn retail commitments should be addressed directly through estimates of EAD rather than incorporating the risk into LGD estimates. To use LGD adjustments properly, they must be a function of the size of the unfunded commitment, which is basically the same as estimating EAD. Conversely, if LGD estimates are independent of the size of the unfunded commitment then the estimate will not properly differentiate similar commitments with the same outstanding balance but significantly different unfunded lines.

Our data suggests that EAD is significantly correlated to PD. Using EAD as a function of PD ensures that EAD is sensitive to current utilization, without creating a more complex framework.

Whether securitized or not, unused commitments represent exposure to the originating institution. Investors in card securitizations are not required to fund additional draws and are protected by structural tests for spread accounts and early amortization.

ANPR:

The Agencies are also seeking views on the proposed approach to defining the risk inputs for the retail A-IRB framework. Is the proposed degree of flexibility in their calculation, including the application of specific floors, appropriate? What are views on the issues associated with undrawn retail lines of credit described here and on the proposed incorporation of FMI in the QRE capital determination process?

ONE:

The proposal requires estimates of probability of default (PD) and loss given default (LGD) independently, while the industry manages exposure based on expected loss (EL) alone. The rules covering retail assets are derived largely from the proposed commercial framework and are not consistent with industry risk management practice. Bank One can certainly calculate PDs, LGDs, and EAD for each of our product segments, the exercise would be merely to fulfill regulatory capital requirements and would add little value to the way we manage the risk of these exposures.

While a PD / LGD foundation is sound for commercial assets where severity is observable on a transaction-by-transaction basis, the framework does not apply well to retail assets. Retail assets typically are managed on a pool basis where there is often a high correlation between the value of the underlying collateral and a borrower's probability of default, making it difficult to separate objectively losses into the components of frequency and severity. Because of the link between PD and LGD, the industry measures and manages risk based on portfolio EL and the volatility around it.

As currently written, the PD / LGD framework provides a potential capital arbitrage based on a firm's definition of default. Since EL is the product of PD and LGD, various combinations of the two parameters are possible for the same EL. The capital requirement for each combination is different, implying volatility around PD and LGD behave differently. While this may be true, analysis to separate PD and LGD behavior can be quite subjective and adds little value to current practice. Accordingly, the retail industry does not measure PD and LGD volatility separately, or the correlation between the two.

ANPR:

The Agencies also seek comment on the competitive implications of allowing PMI recognition for banking organizations using the A-IRB approach but not allowing such recognition for general banks. In addition, the Agencies are interested in data on the relationship between PMI and LGD to help assess whether it may be appropriate to exclude residential mortgages covered by PMI from the proposed 10 percent LGD floor. The Agencies request comment on whether or the extent to which it might be appropriate to recognize PMI in LGD estimates.

ONE:

PMI is used as a prudent risk mitigation tool and should be recognized as such. Most PMI providers are 'AA' and 'AAA'- rated companies. We suggest that the LGD should be permitted to go below 10% so long as the through-the-cycle historical data suggests it is appropriate. In other words, the 10% LGD floor is arbitrary and specifically inappropriate for low loan-to-value loans and loans covered by PMI.

Credit Risk Mitigation

ANPR:

Industry comment is sought on whether a more uniform method of adjusting PD or LGD estimates should be adopted for various types of guarantees to minimize inconsistencies in treatment across institutions and, if so, views on what methods would best reflect industry practices. In this regard, the Agencies would be particularly interested in information on how banking organizations are currently treating various forms of guarantees within their economic capital allocation systems and the methods used to adjust PD, LGD, EAD, and any combination thereof.

ONE:

The banking industry continues to struggle with the issue of joint probability of default. It is particularly difficult to accurately assess the correlation between individual (potentially related) obligors. For guarantees we resort a 'look through' approach on 100% guarantees and a collateral adjustment for partial guarantees. Bank One treats all 100% guarantees as impacting the PD and less than 100% guarantees as factors used for the determination of LGD. In assigning obligor ratings to a customer, credits that are 100%guaranteed are assigned based on the financial condition of the guarantor

While this approach is consistent with ANPR's proposed treatment of guarantees, we are concerned with a potential data capture requirement stated in the ANPR. Under the Guarantees and Credit Derivative section, the ANPR stated that, "The banking organization would be required to assign the borrower and guarantor to an internal rating in accordance with the minimum requirements set out for unguaranteed (unhedged) exposures, both prior to adjustments and on an ongoing basis." We question the need for an independent obligor rating absent the guarantee and suggest that this statement be eliminated from the final rules.

Securitization

ANPR:

The Agencies seek comment on the proposed treatment of securitization exposures under the RBA. For rated securitization exposures, is it appropriate to differentiate risk weights based on tranche thickness and pool granularity?

ONE:

Calibration of RBA risk weights under the current proposal is based on the Peretyatkin / Perraudin study[*] using a constant LGD of 50% regardless of tranche thickness. While this may be appropriate for thin mezzanine tranches, senior thick tranches demonstrate much lower LGD. Appendix A of the American Securitization Forum ANPR response letter dated November 3, 2003 contains a detailed study that shows that LGD ranges from five to ten percent for thick tranches rated 'A' or better. This is true across a variety of asset classes including auto loans, home equities and CDOs. RBA Risk weights for senior thick tranches should be calibrated using the Perraudin and Peretyatkin model and the lower LGD assumption.

[*] Capital for Asset-Backed Securities, February 2003 by Vladislav Peretyatkin and William Perraudin. A paper prepared for the Securitization Sub-Group of the Basel Committee

ANPR:

The Agencies seek comment on the proposed methods for calculating dilution risk capital requirements. Does this methodology produce capital charges for dilution risk that seem reasonable in light of available historical evidence? Is the corporate A-IRB capital formula appropriate for computing capital charges for dilution risk?

In particular, is it reasonable to attribute the same asset correlations to dilution risk as are used in quantifying the credit risks of corporate exposures within the A-IRB framework? Are there alternative method(s) for determining capital charges for dilution risk that would be superior to that set forth above?

ONE:

As proposed under the SFA approach, the inclusion of dilution in the combined exposure fails to recognize recourse to the seller of the receivables for the amount of dilution. When recourse is present, the expected dilution amount is actually an unsecured loan to the seller. We propose that regulatory capital requirements for this exposure be based on the seller's PD and an unsecured LGD using the commercial risk weight function. Dilution risk capital should be added to the results of the SFA calculated for credit risk alone.

Supervisory Standards

ANPR:

The Agencies also seek comment on the supervisory standards contained in the draft guidance. Do the standards cover all of the key elements of an A-IRB framework? Are there specific practices that appear to meet the objectives of accurate and consistent ratings but that would be ruled out by the supervisory standards related to controls and oversight? Are there particular elements from the corporate guidance that should be modified or reconsidered as the Agencies draft guidance for other types of credit?

ONE:

Bank One anticipates that historical data tracking will be a particular challenge in regards to certain data elements and suggest that the agencies be flexible in their requirements. For example, the exact source of a recovery may not always be determinable, especially in instances when pools of assets are being liquidated. Bank One also suggests that language be modified to allow for the possibility of certain missing data elements.

Operational Framework

ANPR:

Does the broad structure that the Agencies have outlined incorporate all the key elements that should be factored into the operational risk framework for regulatory capital? If not, what other issues should be addressed? Are any elements included not directly relevant for operational risk measurement or management? The Agencies have not included indirect losses (for example, opportunity costs) in the definition of operational risk against which institutions would have to hold capital; because such losses can be substantial, should they be included in the definition of operational risk?

ONE:

It will be difficult for institutions to demonstrate that explicit and imbedded dependence (correlation) assumptions are appropriate as insufficient data will be available to statistically validate these assumptions across business lines and event types. Correlations likely will be determined from qualitative reasoning based on the underlying nature of the risks, and the proposal should recognize that qualitative judgment will be necessary. Overly conservative criteria should not be applied to correlation assumptions to avoid penalizing banks that use more risk-sensitive "bottoms-up" approaches.

ANPR:

The Agencies seek comment on the extent to which an appropriate balance has been struck between flexibility and comparability for the operational risk requirement. If this balance is not appropriate, what are the specific areas of imbalance and what is the potential impact of the identified imbalance?

ONE:

Current supervisory practice around information requests is largely unconstrained. First, given the broad implementation of an operational risk management framework, compliance with vague information requests is expensive. Second, specific reports from control self-assessments that detail areas for improvement are likely to be frank when the reports are used internally, but more guarded if regulators and supervisors are allowed detailed access. The analysis and reporting of near misses, potential legal liabilities and opportunity costs raise similar concerns.

ANPR:

The Agencies are introducing the concept of an operational risk management function, while emphasizing the importance of the roles played by the board, management, lines of business, and audit. Are the responsibilities delineated for each of these functions sufficiently clear and would they result in a satisfactory process for managing the operational risk framework?

ONE:

The ANPR requires Board of Director approvals in their oversight and approval of operational risk management frameworks and quantification. Senior management typically provides oversight and approvals for the development and implementation of risk management frameworks (credit, market and operational) with updates provided periodically to the Board. Banks should not be required to do something different under Basel II requirements. The adequacy of corporate governance should be evaluated as a Pillar II concept.

The roles of the Fed, OCC, FDIC, NASD and SEC overlap in the supervision of operational risk management and should be further clarified. It is important that the roles and responsibilities of the various US supervisory bodies be delineated prior to the finalization of operational risk supervisory guidance.

In addition, the ANPR overlaps other supervisory guidance such as FDICIA and Sarbanes-Oxley. Different regulations should not only be drafted for consistency, but also be explicitly evaluated for contradictions. We urge the Supervisors to consider ways to take advantage of these overlaps to reduce the overall regulatory burden of these regulations.

ANPR:

The Agencies seek comment on the reasonableness of the criteria for recognition of risk mitigants in reducing an institution's operational risk exposure. In particular, do the criteria allow for recognition of common insurance policies? If not, what criteria is most binding against current insurance products? Other than insurance, are there additional risk mitigation products that should be considered for operational risk?

ONE:

The 20% ceiling on the amount of capital that can be offset by insurance appears to be adequate until banks are able to demonstrate that the number should be higher. Also insurance provided by captive insurers should be allowed as a capital adjustment provided qualitative criteria are met. The regulations should provide flexibility in allowing recognition of other risk mitigation products that emerge in the future.

Disclosure Requirements

ANPR:

The Agencies seek comment on the feasibility of such an approach to the disclosure of pertinent information and also whether commenters have any other suggestions regarding how best to present the required disclosures.

Comments are requested on whether the Agencies' description of the required formal disclosure policy is adequate, or whether additional guidance would be useful. Comments are requested regarding whether any of the information sought by the Agencies to be disclosed raises any particular concerns regarding the disclosure of proprietary or confidential information. If a commenter believes certain of the required information would be proprietary or confidential, the Agencies seek comment on why that is so and alternatives that would meet the objectives of the required disclosure. The Agencies also seek comment regarding the most efficient means for institutions to meet the disclosure requirements. Specifically, the Agencies are interested in comments about the feasibility of requiring institutions to provide all requested information in one location and also whether commenters have other suggestions on how to ensure that the requested information is readily available to market participants.

ONE:

The semi-annual reporting frequency set out in this proposal is inconsistent with current reporting requirements and practices. We recommend that a full disclosure be required on an annual basis, with key changes highlighted quarterly. This reporting schedule would better align with current disclosure requirements and would reduce the cost and burden of compliance. Also, the United States already mandates board oversight of financial disclosure, so a policy dictating governance and compliance is unnecessary and would prove inflexible in light of ongoing advancement in public reporting.

We agree with the Committee's inclusion of a disclosure exemption for proprietary and confidential information. In addition to the instances cited in the draft, some of the details mandated by the disclosure requirements may inadvertently result in customer information being divulged, leading to privacy issues. This may be particularly true with the requirement for industry data, from which customer information could be distilled. As far as credit risk is concerned, disclosing any geographic, industry, credit grade or other portfolio segmentation will lead to inappropriate conclusions, and these alone do not define portfolio risk. Proper use of the data requires an understanding of the interrelationship between individual segments and the portfolio in total, especially if comparisons across institutions are to be made. We encourage a broadening of the exemption to additional circumstances as warranted.