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November 3, 2003 via email

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Re: **FDIC** RIN 3064–AC73; **FRB** Docket No. R-1154; **OCC** Docket No. 03–14; **OTS** No. 2003–27; Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord; 68 Federal Register 45900; August 4, 2003

Ladies and Gentlemen:

On August 4, the four federal bank regulatory agencies (Agencies) published an Advance Notice of Proposed Rulemaking (ANPR) on how the New Capital Accord, as proposed in the Basel Committee on Banking Supervision's Third Consultative Paper (CP3), would be implemented in the United States. The ANPR also contains a "Draft Supervisory Guidance on the Internal Ratings-Based Systems for Corporate Credit and Operational Risk." This letter is the response of the American Bankers Association (ABA) to the ANPR. In a separate letter, the ABA provided comments on the "Draft Supervisory Guidance on Operational Risk Advanced Management Approaches for Regulatory Capital." The ABA brings together all elements of the American banking community to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings institutions, trust companies and savings banks – makes ABA the largest banking trade association in the United States.

General Comments

Over the past several years, the Basel Committee, of which the Agencies are members, has been revising the international regulatory capital standard. The Committee intends to develop more risk-sensitive capital requirements, as has become necessary for the supervision of globally active, major banks. U.S. banks that will be subject to the New Accord have been urging the Agencies to make such risk sensitive changes to capital requirements for some time, and ABA supports the efforts of the Agencies to revise the current Accord. In fact, ABA commends the Agencies for the progress made by them and the Committee to address many of the deficiencies of the current Capital Accord as well as earlier drafts of the New Accord. However, we still have significant concerns about the form of the proposed New Accord, as set out in the Agencies' ANPR. In summary, our reactions to the proposal are:

- We support the concept that the New Accord should only be applied to the largest internationally active banks and others that elect to adopt its requirements (the A-IRB banks). The complex standard is not appropriate for most small community banks, which do not have the need to implement it and which would find it very burdensome (the non-A-IRB banks).
- However, there is potential for the New Accord to create competitive inequalities between A-IRB and non-A-IRB banks in the U.S., between banks and non-bank financial institutions in the U.S., and between A-IRB U.S. banks and foreign financial institutions globally.
    - It is imperative that the Agencies monitor the impacts of the New Accord to watch for evidence that non-A-IRB banks are having trouble competing due to differences in capital requirements not based on bank safety and soundness.
    - The Agencies should hereafter more flexibly adjust U.S. capital rules for non-A-IRB banks when appropriate, now that the U.S. capital requirements, aside from the New Accord rules for A-IRB banks, are purely domestic standards.
    - If the U.S. banking system becomes adversely affected by the New Accord – domestically or internationally – then appropriate changes in the framework and its scope of application within the U.S. should be made.
- The Basel Committee and Agencies should adopt the principle of "lead supervision," whereby a regulator from a bank's home country is responsible for the global supervision of that bank.
- The Agencies should commit to reduction of the leverage ratio standard and amendment of the Prompt Corrective Action (PCA) rules to allow the New Accord to work.
- There continue to be concerns about the timing of implementation of the New Accord, especially since additional comments are needed on revisions outlined but not detailed by the Agencies in October 2003. A final rule should not be adopted until the results of next year's Quantitative Impact Study are analyzed, and implementation should be correspondingly delayed.

In addition to these general concerns, we also include a number of specific concerns about the New Accord, as set out below in the Specific Comments.

<u>We support the concept that the New Accord should only be applied to the largest internationally active banks and others that elect to adopt its requirements.</u> Our largest internationally active banks have long urged the Agencies to revise the current Accord to make it more risk sensitive. ABA has long supported the goals of the proposed revision:

- to better align regulatory capital standards with the underlying economic risks incurred by a banking firm,

- to encourage better risk measurement and management, and
- to promote international consistency in regulatory standards.

Further, we support the intent to establish capital regulations that not only encompass minimum capital requirements but also include supervisory review and market discipline in a comprehensive approach to regulation of risk-based capital. We believe that the proposed New Accord is approaching these goals. However, when it became apparent in early proposals that the New Accord would be very complex and an enormous burden for the vast majority of U.S. banks, ABA strongly urged that the New Accord be applied only to the small number of institutions for which this degree of intricacy is warranted. We still hold to this position.

<u>However, there is potential for the New Accord to create competitive inequalities between A-IRB and non-A-IRB banks in the U.S., between banks and non-bank financial institutions in the U.S., and between A-IRB U.S. banks and foreign financial institutions globally.</u> The ABA takes the question of competiveness disadvantage arising from the New Accord very seriously. First, the proposed application of the New Accord only to A-IRB banks poses a fundamental policy issue: does bifurcation of capital regulation into two parts – A-IRB for the largest, internationally active banks *versus* the current standard formula for all other banks – create significant competitive advantages or disadvantages for any group of banks? In particular, if the results of last year's Quantitative Impact Study hold true, then the capital required for A-IRB banks will be significantly reduced.[1] In this case the small group of large institutions *may* be competitively advantaged over all other banks in:

- leveraging their capital to acquire other institutions;
- bidding for loans and securities; and
- attracting deposits and funding in the financial markets.

At the same time, we recognize that any capital standard has an impact on competition. For example, until recently the overly-simplistic measures in the current Accord afforded competitive advantages for banks with large off-balance sheet exposures. Thus, we believe that if the New Accord establishes capital requirements that are commensurate with risk exposure, and thereby improves safety and soundness supervision of more complex, large institutions, then a bifurcation of capital regulation can make sense.

Nonetheless, questions remain as to whether the proposed New Accord does this or instead creates ***unfair*** competiveness advantages for any group of banks. The barrier between A-IRB banks and others is steep due to the high cost of the risk measurement technology. We anticipate that this barrier will decline in the future, as the technology matures so that banks have to pay only for installation of better-understood process and not product development. As a result, more and smaller banks will be able to adopt advanced approaches. Nonetheless, the demands of the A-IRB process will always be excessive for most community banks. Therefore, ***if there are competitive inequities, then their adverse effects on community banks will grow with the number of A-IRB adopters***.

[1] However, if the leverage ratio and PCA rules are unchanged, it is not clear that the A-IRB banks will gain any reduction in capital requirements, as discussed below.

Will a bifurcation of capital standards lead to more industry consolidation? Will A-IRB banks achieve competitive benefits in terms of pricing credit and enhanced returns? What are the competitive implications for community and mid-size regional banks? Would institutions be compelled for competitive reasons to opt-in to the advanced approaches? These are very important questions for our non-A-IRB banks; but before the new rules are put in place, how non-A-IRB banks will be affected would only be speculation. We do not believe that the Agencies, the ABA, or any of our banks can reasonably answer these questions at this time. But just because we cannot answer these questions now does not mean that we should ignore them.

<u>It is imperative that the Agencies monitor the impact of the New Accord for evidence that non-A-IRB banks are having trouble competing due to differences in capital requirements not based on bank safety and soundness</u>. The Agencies have stated an intention to carefully monitor the economic effects of the New Accord, watching the consequence for individual banks as well as the industry. These follow-up steps are very important to the banking industry. We suggest that the Agencies focus their monitoring on whether:

- Non-A-IRB bank loan or deposit growth rates decelerate as compared to A-IRB banks,
- Deposits become more concentrated in A-IRB banking firms,
- Net interest margins or other retail product prices change for non-A-IRB *versus* A-IRB banks,
- A-IRB bank capitalization declines and return on equity rises, as compared to non-A-IRB banks,
- Lower capital requirements allow A-IRB banks to pay higher dividends,
- A-IRB banks become more active in acquiring smaller institutions, and
- There are immediate effects that grow over time in these indicators.

<u>The Agencies should hereafter more flexibly adjust U.S. capital rules for non-A-IRB banks when appropriate, now that the U.S. capital requirements, aside from the New Accord rules for A-IRB banks, are purely domestic standards</u>. If the Agencies observe competitive inequities arising from the bifurcation of capital standards as a result of monitoring the indicators above, then the Agencies will need to make appropriate changes to the capital standard applying to non-A-IRB banks. We believe that the Agencies should be able to make appropriate changes quickly to adjust for such inequities. With the adoption of a New Accord, the current Accord, which will continue to apply to non-A-IRB banks, will no longer be part of an international capital agreement but rather will just be a domestic capital standard. The Agencies therefore will no longer need to obtain international agreement for changes to that capital standard, as they do now. This should allow the Agencies, as they continually review these capital standards, to modify rapidly the domestic bank capital standard to improve its risk sensitivity as well as to reduce any inappropriate capital impact of the bifurcation of capital standards.

As one example of possible changes to the current capital standard, we note that under the New Accord's "Standardized Approach" (which will not be an option in the U.S.), the risk weight for qualifying residential mortgage loans is 35 percent. In contrast, the risk weight currently in place is 50 percent, which will continue to apply to all U.S banks except the few under the New Accord. We recommend that with the adoption of the New Accord, the Agencies consider lowering the risk weight of residential mortgage loans as an amendment to the non-A-IRB capital standard that should make it more risk sensitive while clearly reducing the possible competitive impact of the bifurcation of capital standards. We believe that the Agencies can make the current capital standard much more risk sensitive and efficient with relatively simple changes, and we urge the Agencies to do so.

If the U.S. banking system becomes adversely affected by the New Accord – domestically or internationally – then appropriate changes in the A-IRB framework and its scope of application within the U.S. should be made. A-IRB banks are also concerned about possible competitive inequities created by the New Accord: these concerns are about domestic competition and international competition. With respect to financial services providers that are not subject to bank capital rules, for years major banks have been calling for more risk-sensitive capital standards to create a level playing field. Many non-banking financial and even commercial firms offer banking services but are not subject to the capital rules. For example, GMAC offers consumer credit and home mortgage lending. While the New Accord strives to address these inequities, it may be that it will not completely resolve this issue. To the extent that the New Accord results in the A-IRB banks having to hold more capital than their own internal models indicate or than is required by regulators or the funding markets of non-bank rivals, we would urge appropriate changes. An example of concern over provisions of the New Accord is in the capital treatment of commercial real estate loans. The capital set-aside requirement for life insurance companies for commercial real estate loans in good standing averages 1.92 percent (according to the National Association of Insurance Commissioners) – well below the 4-to-6 percent requirement for the highest quality commercial real estate loans under the New Accord. The effect of these differences will also need to be monitored and appropriate changes made.

Additionally, U.S. A-IRB banks have legitimate concerns that they may be disadvantaged in international business relative to foreign banks based on national discretion in the application of the New Accord. U.S. regulators tend to take a more conservative approach than their foreign counterparts, as demonstrated by the fact that U.S. banks are effectively required to hold considerably more capital than the minimum under the current or future Accords in order to qualify as "well capitalized" under U.S. law. If certain nations favor their banks, then these banks may even be able to exploit their regulatory advantages ***in the U.S.*** through branches and affiliates in this country. ***It is essential that the New Accord be implemented in a synchronized, symmetrical fashion on a global basis. Through participation in the Basel Committee's Accord Implementation Group, the Agencies need to monitor and make appropriate changes in the framework for differential applications of the New Accord across nations.***

The Basel Committee and Agencies should adopt the principle of "lead supervision," whereby a regulator from a bank's home country is responsible for the global supervision of that bank. Related to the issue of international competitiveness and the considerable national discretion allotted to supervisors to vary capital under the New Accord, institutions operating in multiple jurisdictions are concerned about being subject to multiple, potentially conflicting interpretations of the new, complex standards. We believe that the best solution would be for the Basel Committee and Agencies to adopt the principle of "lead supervision," in which a single regulator, usually in the institution's home country, would be responsible for the global supervision of the institution. This approach should enhance cooperation among regulators by requiring more communication across borders and the delegation of responsibilities by the lead supervisor. For the supervised institutions, this approach would prevent duplicate reviews and contradictory requirements from different regulators.

The Agencies should commit to reduction of the leverage ratio standard and amendment of the PCA rules to allow the New Accord to work. The Agencies need to consider the competitiveness impact of maintaining the present leverage ratio and the PCA requirements. The ANPR states:

"Banking organizations would continue to be subject to a leverage ratio requirement under existing regulations, and PCA legislation and implementing regulations would remain in effect." While we understand that the Agencies need a period of transition to be sure that the New Accord is adequately capturing and capitalizing risks in the bank, ABA believes that ***the Agencies must commit to reduction of the leverage ratio standard and amendment of the PCA rules to allow the New Accord to actually benefit accurate risk measurement and capitalization by A-IRB banks.***

As the Agencies are well aware, having gone through three Quantitative Impact Studies, the modeling requirements of the New Accord are severe. And institutions that nonetheless elect to implement internal models approaches must anticipate an ongoing supervisory burden to continually justify their models. The point of this effort is better risk management backed by the appropriate amount of capital. That the Agencies would then require A-IRB banks to measure their capital management needs based on an additional, totally arbitrary leverage measure defeats the entire purpose.

Table 1 below shows how the largest U.S. banks are constrained by the three components of the PCA rules. In order to be "well capitalized," a bank must have at least a five percent leverage capital ratio, six percent Tier 1 capital ratio, and ten percent risk-based capital ratio. It is obvious that these banks feel constrained to meet the well-capitalized standard – and be free of additional regulatory restrictions or market criticism – since all of the banks meet all three of the tests. Currently, most of the largest banks are more constrained by the leverage capital test than the Tier 1 or risk-based capital tests. However the A-IRB process would affect the Tier 1 and risk-based capital ratios, but not the leverage capital ratio.[2] Therefore, the most binding regulatory standard would not be affected by the New Accord, and A-IRB banks would have to continue to hold just as much capital as at present to be well-capitalized by the leverage ratio test in PCA, no matter how much capital the Tier 1 or risk-based capital ratios call for. As a result, they reap no benefit for their expenditures in resources and effort to develop more risk sensitive capital models and institutions that might opt-in would be disincented to invest the time and capital to adopt advanced measurement approaches.

[2] The Tier 1 and risk-based capital ratios are calculated by dividing core capital and total capital, respectively, by risk-weighted assets. At present, the risk-weighted assets denominator is calculated by all banks using the same formula. The New Accord would authorize the A-IRB banks to calculate risk-weighted assets more carefully using internal models. In contrast, the core or leverage capital ratio, core capital divided by average total assets, would not be affected by the New Accord.

Table 1

Leverage and Prompt Corrective Action Capital Ratios of the Largest 15 Banks as of June 30

Bank	Assets ($Billions)	Core Capital (Leverage)	Tier 1 Capital	Risk-Based Capital
JPMorgan Chase Bank, New York City, NY	$662	5.4%	8.3%	11.0%
Bank of America, National Association, Charlotte, NC	$656	6.5%	8.1%	10.7%
Citibank, National Association, New York City, NY	$523	6.4%	8.4%	12.6%
Wachovia Bank, National Association, Charlotte, NC	$332	6.4%	7.8%	11.9%
Washington Mutual Bank, FA, Stockton, CA	$241	5.8%	9.4%	11.5%
Bank One, National Association, Chicago, IL	$231	7.6%	9.7%	13.5%
Wells Fargo Bank, NA, San Francisco, CA	$203	6.6%	7.7%	12.0%
U.S. Bank National Association, Cincinnati, OH	$192	7.3%	7.7%	12.0%
Fleet National Bank, Providence, RI	$191	8.0%	8.5%	11.4%
SunTrust Bank, Atlanta, GA	$119	7.5%	7.7%	10.7%
The Bank of New York, New York City, NY	$96	5.9%	6.9%	11.2%
HSBC Bank USA, Buffalo, NY	$90	6.0%	8.7%	12.1%
Citibank (West), FSB, San Francisco, CA	$76	7.1%	12.6%	15.6%
State Street Bank and Trust Company, Boston, MA	$75	5.2%	13.4%	13.5%
Keybank National Association, Cleveland, OH	$75	6.8%	6.8%	11.1%

* Required to be "well capitalized": 5% core capital, 6% Tier 1 capital and 10% risk-based capital

<u>There continue to be concerns about the timing of implementation of the New Accord, especially since additional comments are needed on revisions outlined by the Agencies in October 2003. A final rule should not be adopted until the results of next year's Quantitative Impact Study are analyzed, and implementation should be correspondingly delayed.</u> While the ANPR follows the proposed New Accord as set out in the CP3, the Basel Committee on October 11, 2003, announced major changes in its proposal. Thus, while our comments herein address the ANPR as published, we must recognize that the ANPR is out of date with respect to the draft New Capital Accord. The Basel Committee has now stated that it is amending the draft by:

- changing the overall treatment of expected *versus* unexpected credit losses;
- simplifying the treatment of asset securitization, including eliminating the "Supervisory Formula" and replacing it by a less complex approach;
- revisiting the treatment of credit card commitments and related issues; and
- revisiting the treatment of certain credit risk mitigation techniques.

While these changes appear to improve the proposed New Accord, further detail from the Agencies and additional analysis by our banks are required. This is particularly true with respect to the change in the treatment of Expected Losses, as discussed below in the Specific Comments.

On October 30, 2003, the Agencies announced that they would accept comment on the removal of Expected Losses from the New Accord up until December 31, 2003. We appreciate the additional time for comment, particularly since we note that the Agencies in the ANPR expressed considerable concern about the extent of changes that would be required to the proposed New Accord if Expected Losses were to be removed from the framework. The ANPR even suggests that such a change would require alteration of the definition of capital[3] and significant recalibration of the framework.[4] Naturally, this has led the Basel Committee to push the time for final implementation out for another six months.

As our banks consider these changes and the practicalities of implementing the New Accord, they are growing concerned that the timeframe is very tight for implementation in 2007, as proposed by the Agencies. A key problem is that the system requires three years of past risk data, which means that data collection must begin next year to be implemented in 2007, meaning that data collection methods have to be finalized, to supervisors' satisfaction, by the end of this year. This timeframe will be very difficult to achieve, given that the ANPR has only recently revealed the Agencies' first thoughts on how the New Accord will be implemented in this country. We understand that other of the G-10 national bankers' associations are also concerned about the current implementation timeframe. We believe that the Agencies will need to continuously monitor implementation by banks with an eye to delaying the implementation. The Agencies need to further delay implementation to prevent changes by the Committee from overrunning the Agencies' regulatory process, as just happened with the recently announced changes to the proposed New Accord.

Specific Comments

While ABA generally supports the progress made in the New Accord, as reflected in the ANPR, we still harbor concerns over some specifics of the proposal.

- Capital should not be required for expected losses.
- The collective conservatism in New Accord raises the proposed capital requirements above the goal of true minimum standards.
- Under the A-IRB approach, an institution's regulatory capital should be determined solely using internal models, regardless of risk type – *i.e.*, for credit, market and operational risks – subject to supervisory oversight.
- The A-IRB approach should not specify limits for parameters.

[3] "The Agencies recognize that some institutions, in their comment letters on earlier Basel Committee proposals and in discussion with supervisory staffs, have highlighted the view that regulatory capital should not be allocated for Expected Loss. They emphasize that Expected Loss is normally incorporated into the interest rate and spreads charged on specific products, such that Expected Loss is covered by net interest margin and provisioning. The implication is that supervisors would review provisioning policies and the adequacy of reserves as part of a supervisory review, much as they do today, and would require additional reserves and/or regulatory capital for Expected Loss in cases where reserves were deemed insufficient. However, the Agencies are concerned that the accounting definition of general reserves differs significantly across countries, and that banking practices with respect to the recognition of impairment also are very different… The Agencies also note that the current regulatory definition of capital includes a portion of general reserves. That is, general reserves up to 1.25 percent of risk-weighted assets are included in the Tier 2 portion of total capital. If the risk weight functions were calibrated solely to UL, it could be argued that the definition of capital would also need to be revisited. In the United States, such a discussion would require a review of the provisioning practices of institutions under GAAP and of the distinctions drawn between specific and general provisions." 68 Fed. Reg. 45909.

[4] "The framework described in this ANPR calibrates the risk-based capital requirements to the sum of Expected Losses plus Unexpected Losses, which raises significant calibration issues. Those calibration issues would be treated differently if the calibration were based only on the estimate of Unexpected Losses. That is, decisions with respect to significant policy variables that are described below hinge crucially on the initial decision to base the calibration on Expected Loss plus Unexpected Loss, rather than Unexpected Loss only. These issues include, for example, the appropriate mechanism for incorporating any future margin income that is associated with particular business lines, as well as the appropriate method for incorporating general and specific reserves into the risk-based capital ratios." 68 Fed. Reg. 45910.

- The capital treatment of highly volatile commercial real estate is still too onerous.
- The securitization framework remains highly complex and potentially quite burdensome.
- The treatment of credit card commitments and other similar credit lines is also too onerous.
- The New Accord inadequately considers the full economic benefit of risk mitigation and diversification.
- The treatment of credit hedging should be modified to (1) recognize the lower risk of joint default and (2) relax the overly conservative rules on maturity mismatches.
- The treatment of operational risk, in Pillar 1 or Pillar 2, should be flexible and non-prescriptive to allow development of this new science.
- Transparency needs to be improved for supervisory standards for requiring additional capital under Pillar 2.
- Before requiring additional disclosures under Pillar 3, the Agencies and the Committee should coordinate any new requirements with non-bank financial regulators and IOSCO.

Pillar 1

<u>Capital should not be required for expected losses.</u> In the ABA's response to the CP3 on the inclusion of Expected Losses in credit risk, ABA urged that:

- Regulatory capital for credit risk exposures should be required only for Unexpected Losses, not for Expected Losses, and
- If Expected Losses continue to be included, then the definition of capital should be changed to include more loan loss reserves in Tier 1 capital and to allow more than 75 percent of future margin income as offset to Expected Losses.

The Basel Committee has now proposed to transform the treatment of Expected Losses. The Committee states that the measurement of risk-weighted assets in the A-IRB approaches would be based solely on the Unexpected Loss portion of the IRB calculations. Accordingly, certain offsets within the IRB framework, in particular future margin income, would no longer be necessary. However, there would be a new, separate treatment of Expected Losses to ensure that banks provision properly against Expected Losses. Banks will compare the IRB measurement of Expected Losses with their total loss reserves, including both general and specific provisions. For any individual bank, this comparison will produce a <u>shortfall</u>, if the Expected Loss amount exceeds the reserves, or an <u>excess</u>, if the reserves exceed the Expected Loss amount. <u>Shortfall</u> amounts will be deducted from capital, taken half from Tier One capital and half from Tier Two capital. <u>Excess</u> provision amounts, if any, would be eligible as Tier Two capital, similar to the current treatment of general provisions. The Tier Two eligibility could be limited at supervisory discretion, but in no case would be allowed to exceed 20 percent of Tier Two capital. This treatment of shortfall and excess amounts would be in *lieu* of the current inclusion of general provisions in Tier Two capital.[5]

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[5] The Basel Committee's announcement further states: "It is important to note that the incorporation of this new approach into the IRB framework may require some recalibration of that framework to ensure that the overall impact of its proposals is consistent with the Committee's objectives. The Committee is undertaking further efforts to identify where such adjustments may be needed." ABA is concerned that any adjustments made by the Basel Committee to the framework are not included for discussion in the Agencies' ANPR and cannot be anticipated by commenters on the ANPR.

Our initial impression of this change is that it improves on the proposal in the ANPR, as it appears to address a major concern of our banks about the New Accord. However, we feel that the last-minute change is sufficiently significant that it warrants deeper consideration before we can fully comment. Further, any final analysis of the proposed new treatment of Expected Loss must consider recent proposals for changes to the accounting treatment of reserves. Recent interpretations by the Financial Accounting Standards Board are moving Generally Accepted Accounting Principles (GAAP) away from reserves for credit losses that are not specific to individual events. This interpretation could significantly alter reserving practices of banks with respect to unallocated reserves. In fact, the Agencies have just filed a comment letter on the American Institute of Certified Public Accountants' proposed new treatment of unallocated reserves strongly urging the proposal be abandoned. Until the question of any change in GAAP with respect to reserving for losses is resolved, it appears to us that the final treatment of Expected Loss under a new U.S. capital adequacy guideline will be premature. Therefore, ***we cannot address the proposed new treatment of Expected Losses in this comment on the ANPR, but rather must wait until we can obtain additional information from the Agencies and can consult with our members on this major change.***

While we are not ready to respond to the reproposed treatment of expected <u>credit</u> losses, we are clear on the companion proposal for expected <u>operating</u> losses. The change proposed on October 11 appears to apply only to <u>credit</u> loss exposure, excluding <u>operating</u> loss exposure. The logic is no different for operating loss exposure than for credit loss exposure. While more attention has been given to offsets for credit, as compared to operating, loss exposures, in the past, this does not justify differing treatment. Many institutions, particularly the A-IRB banks, are now formalizing structures for reserves and product pricing offsets for operating risks, and therefore ***recommend the same treatment of Expected Losses for operating loss exposure as for credit loss exposure.***

<u>The collective conservatism in the New Accord raises the proposed capital requirements above the goal of true minimum standards.</u> U.S. banks are unanimously concerned about the cumulative effects of conservative decisions that move the Accord away from being true minimum standards, with Pillar 2 to handle any additional risks. Moreover there is no allowance for diversification across business lines (*e.g.*, with deconsolidated insurance), asset classes (*e.g.*, retail and wholesale portfolios), risk types (credit, market and operational) or geographically. (Diversification needs to be fully and explicitly incorporated into the New Accord.) And risk mitigation is not given sufficient weighting. In totality, the effect is to raise capital requirements above what is needed for safety and soundness to the detriment of bank credit and services.

Examples of collective conservatism include:

- The capital requirements for retail exposures (mortgages, revolving credits and non-mortgage non-revolving credits) are too high (primarily due to the inclusion of Expected Losses, discussed above) and the Asset Value Correlations to default probabilities are also too high.
- In particular, the losses given default (LGDs) on residential mortgages must be at least ten percent, and the asset value correlation (AVC) at least 15 percent.
- Excessive risk parameters are specified for land acquisition, construction and development loans for single-family housing; multifamily, office, industrial and retail commercial property; and commercial real estate ADC loans.
- The capital requirement for commercial and residential mortgage-backed securities has a 56 basis point minimum.

- The risk-reduction benefit for guarantees through "joint probability of default" is only partially recognized.
- Strict matching is required for risk-reduction provided by credit default swaps.
- The 99.9 percent confidence levels for credit and operational risk models equate to an investment grade or "well capitalized" target level of capital, rather than a minimum standard.
- The twenty percent limit on insurance-related capital benefits for operational risk is unnecessary.
- The floor capital charge in the SFA for securitizations is too high and does not take structural mitigants into account.

<u>The New Accord should implement a full internal models-based approach for regulatory capital.</u> For large, complex banks, the A-IRB process in New Accord is a major improvement over the regulator-generated risk-weight formula of the original Accord. Nonetheless A-IRB banks generally agree that the proposed approach falls short of a capital standard based on best-efforts internal assessments of risk exposure.

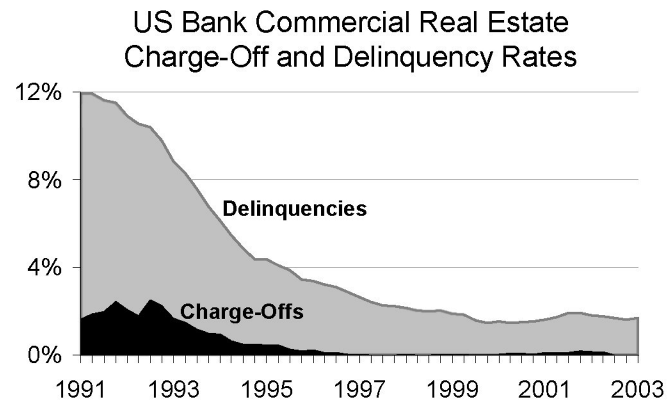
Under the A-IRB approach, an institution's regulatory capital would be determined solely using internal models, regardless of risk type for credit, market and operational risks, subject to supervisory oversight. Credit and market risk data and quantification techniques are well developed, and operational risk assessment, while in its infancy, allows for and even encourages A-IRB. However, prescribed restrictions and limits on modeling, such as for equity exposures, fall short of full internal modeling.

<u>The A-IRB approach should not specify limits for parameters</u>. The Basel Committee should remove the floors and ceilings (especially in retail) and fixed values (especially in retail and corporate) for parameters in banks' internal models. Instead, these values should be determined empirically by each institution.

Arbitrary minimums discourage institutions from measuring or managing risk closely. On the other hand, supervisory review and validation of bank probabilities of default, losses given default, and exposures at default (PDs, LGDs, and EADs) – a prerequisite for the use of internal data in the regulatory capital calculations – provides sufficient oversight without arbitrary minimums and maximums. During this review process, concerns surrounding assumptions and data calculations will be raised and dealt with. If during this process examiners conclude that a bank has not shown proper back-up for its inputs, they can require additional conservatism in the parameters.

<u>The capital treatment of highly volatile commercial real estate is still too onerous.</u> CP3 reduced capital charges for highly volatile commercial real estate from the prohibitive levels of the Second Consultative Paper and the Technical Guidance of the Third Quantitative Impact Study (QIS3). However, minimums remain above levels U.S. banks use for internal economic capital purposes.

In the New Accord, A-IRB banks can use the corporate asset risk class formula to determine risk weights for commercial real estate, classified either as income producing or high-volatility (HVCRE). However, for HVCRE a substitute asset correlation formula is required in place of the asset correlation function currently assigned to the corporate risk class formula. The Basel Committee required the substitute, warranting higher correlations and capital charges, based on concerns that, in the past, commercial real estate has at times suffered systemic downturns.



Data from the Federal Deposit Insurance Corporation

ABA recommends that this premise be reviewed. Commercial real estate has become less volatile over the last decade. The change is due to stronger underwriting, including more borrower equity and better appraisal procedures and credit scoring. This fact has been confirmed by the industry's reduced loan loss experience over the last decade (see chart). Moreover, securitization of commercial mortgage-backed securities (CMBS) has improved discipline, transparency and liquidity in commercial real estate lending.

ABA recommends that the certification process for the use of bank-specific parameters be no different than for corporate exposures. We further urge that all commercial real estate should be categorized as income producing, eliminating the HVCRE category.

<u>The securitization framework remains highly complex and potentially quite burdensome</u>. The capital requirements are unduly conservative relative to the associated retained risks, particularly for liquidity facilities for asset-backed commercial paper conduits (ABCPC). The requirement that originators hold more capital than investors for similar risk exposures is overly conservative and unnecessary, creating a market preference for creation over holding. We believe that originators should not be burdened with higher capital requirements compared to investors in equivalent risk positions. Under the A-IRB approach, institutions should use internal ratings to determine risk weights, especially for ABCPC.

We do not believe that undrawn, uncommitted credit lines related to revolving accounts included in securitization transactions should require capital. In typical revolving securitization structures, both current drawn balances and future customer draws, are included, so that during the revolving period, investors do not have the ability to choose whether or not to purchase newly originated loans. Neither do they have the ability to purchase only low risk receivables. Instead, investors are required to purchase receivables on a *pro rata* basis from all accounts in the securitization vehicle. Thus we find no basis for the attempt to require additional capital for undrawn lines.

<u>The treatment of credit card commitments and other similar credit lines is too onerous.</u> The A-IRB approaches would require a new capital charge for unsecured retail exposures. This conservative capital treatment appears to be an attempt to offset lower regulatory capital requirements for other asset types. It is critical that capital requirements not overestimate risk exposures and put U.S. A-IRB banks at a competitive disadvantage in unsecured retail lending.

We believe that there are sufficient differences between revolving retail credit portfolios and corporate credit portfolios that applying a corporate credit model (which is based on single credit exposures) to retail credit portfolios (which are managed pools of individual exposures) appears to be invalid. Any credit model that is ultimately adopted for retail lending must be sound and more than simply a modified version of the corporate credit model. The unique attributes of the retail framework (definition of default, portfolio segmentation, predictable expected losses, loans priced to cover expected losses, asset value correlation, *etc.*) require more review and analysis.

Further, the capital requirements for credit card loans under the IRB approach are higher than both the requirements of the current Accord and of the standardized approach of New Accord (which will not be available in the U.S.). Our banks believe that substantial recalibration of the A-IRB will be necessary to correct these major differences.

Finally, the potential risks of additional draws from uncommitted retail credit lines that can be terminated at will by a lender do not warrant a charge for additional capital. The risks associated with undrawn, uncommitted lines for unsecured retail loans are very low, particularly when they are closely monitored and readily cancelable by the lender.

<u>The New Accord inadequately considers the full economic benefit of risk mitigation and diversification</u>. For credit risk, the proposed substitution approach does not recognize the lower joint risk of default and recovery, and accordingly does not appropriately reflect the risk of these transactions. The treatment of credit hedging should be improved significantly by recognizing the lower risk of joint default and by modifying overly conservative rules on maturity mismatches.

The New Accord recognizes credit risk hedging and guarantees by substituting the default probability of the guarantor for that of the borrower when determining the risk weight. However, both the obligor and guarantor must default for an institution to experience a loss on a hedged exposure, and even in this case the institution can seek recovery from both counterparties. The New Accord should recognize the lower probability of joint default and loss-given default of joint recovery. Institutions should be permitted to calculate joint default probabilities using the same correlations as elsewhere in the regulatory framework for corporate exposures (*i.e.*, twenty percent). A joint loss-given-default is appropriate if an institution can pursue recoveries from both counterparties.

The treatment of maturity mismatches is unduly conservative and unnecessarily complex. The proportional adjustment mechanism is far more conservative than the treatment of maturity for corporate exposures. There is no reason to implement two separate sets of maturity adjustments. Instead, maturity mismatches between credit hedges and the underlying assets should be treated as a forward credit exposure using the A-IRB approach, with a capital offset for the hedge. The counterparty risk should be reflected as an exposure with joint default probability and recovery.

The New Accord should recognize the benefit of the hedge with maturity less than one year when the maturity of the hedged asset is longer than one year. The value of the hedge declines – but does not disappear – as it approaches maturity. We recommend that the risk associated with the shorter maturity be calculated using the corporate A-IRB risk weighting function with a maturity adjustment.

For operational risk, there is inadequate credit for risk mitigation. The New Accord allows limited benefit from insurance programs and does not recognize other legitimate, developing risk transfer techniques – *e.g.*, catastrophe bonds. To flexibly allow for new risk mitigation devices and encourage best practices in operational risk management, the proposal needs to be revised to allow institutions to assess operational risk mitigation internally, subject to supervisory review.

In a broader sense, diversification is an important and effective risk-mitigation technique. The New Accord needs to acknowledge and provide lower capital charges for diversification in the broadest sense. This will encourage sound risk management and lower overall risk exposure.

<u>The treatment of operational risk, in Pillar 1 or Pillar 2, should be flexible and non-prescriptive to allow development of this new science.</u> The New Accord offers more flexibility in determining regulatory capital for operational risk than the First or Second Consultative Papers. Some U.S. A-IRB banks are satisfied that the rules are now more acceptable with the Advanced Measurement Approaches (A-IRB) framework and fully support implementation of operation risk under Pillar 1. Other U.S. A-IRB and non-A-IRB institutions are not satisfied with this approach. The institutions that are not satisfied feel strongly that the explicit capital charge for operational risk should be removed from Pillar 1 and incorporated into the assessment of this risk under Pillar 2 supervisory review. They feel that the current state-of-the-art for operational risk measurement has not progressed sufficiently to warrant its use in regulatory capital standards. Thus our largest banks continue to be unable to craft a consensus on the appropriate treatment of operational risk.

However, the Agencies have also issued a proposed supervisory guidance on operational risk. And there is a strong consensus among A-IRB banks on some key points of the supervisory guidance. ABA submitted a separate letter on the "Draft Supervisory Guidance on Operational Risk AMA" based on input from ABA's Operational Risk Committee, which formed to develop a database of operational loss statistics for benchmarking purposes. The consensus of the Committee, as explained in that letter, is that:

- Banks should be allowed to determine which combination of elements is appropriate to assess and manage operational risk internally, as long as they can defend the appropriateness of their methodology and underlying assumptions to supervisors.
- Supervisory flexibility is needed and regulatory mandates and specific quantitative tests or requirements should be avoided. The goal is to encourage good operational risk management, not driven by arbitrary standards.
- The use of external data to benchmark performance should be encouraged. Addressing industry concerns about confidentiality of external data will help to foster convergence in the methodologies for measuring and managing operational risk and facilitate more scenario testing.

Pillar 2

Transparency of the standards for requiring additional capital needs to be improved. There are no precise guidelines in CP3 for when an examiner should raise the capital requirements for a bank or by how much. On July 7, the bankers' associations of the G-10 countries, including the ABA, submitted to the Basel Committee a letter detailing concerns over Pillar 2's perceived lack of transparency in standards and procedures for allowing supervisors to require additional capital (copy attached). Basel Committee Chairman Jaime Caruana responded on July 25 stating that further explication of the principles of Pillar 2 will be given soon, but it has not happened yet. Therefore, our banks remain apprehensive that Pillar 2 will only be used to raise capital requirements above the Pillar 1 minimums and will never be used to lower capital requirements when warranted. Further, as noted in our letter, all of the G-10 Banking Associations are concerned about differences in application between countries.

Even within the U.S., since Pillar 2 gives examiners the discretion to raise capital requirements, we feel the Agencies need to develop consistent guidance, direction and training to ensure objective assessments. In addition, underlying principles must be consistently applied across the supervisory agencies, as well as within a particular agency as it reviews individual banks. Just as regulators want banks to be more transparent, we believe the regulatory process that leads to a demand for more capital under Pillar 2 also needs to be much more transparent.

Pillar 3

Before requiring additional disclosures under Pillar 3, the Agencies and the Committee should coordinate any new requirements with non-bank financial regulators and IOSCO. ABA supports the Basel Committee's stance on the importance of market discipline and believes that disclosure of all relevant information plays an important role. However, transparency is better achieved by the clear presentation of important information than by dissemination of large amounts of hard-to-interpret data.

Our institutions believe that Pillar 3, while significantly improved in CP3, remains too burdensome and detailed. Pillar 3 would require detailed disclosure of risk profiles, especially for the credit portfolio. Banks that show a risk profile significantly worse than their peers, even if the bank's returns are greater, may well be punished by the market as outliers; consequently they may be driven away from lending to lower-rated borrowers. The additional disclosure will also require a new reconciling event for banks and the investment community, since no two banks will use exactly the same rating system. The risk of misinterpretation of the required information and the burden its distribution will place on banks far outweigh its potential benefit.

We recommend that the Agencies remove from the final rule the proposals in CP3 Table 6(g) for quantitative disclosures of estimated *versus* actual credit risk statistics. Until banks and supervisors have learned from actual implementation experience whether this data is meaningful in the context and format of public disclosure, disclosure of this data should not be required.

Before requiring additional disclosures, we urge coordination with non-bank, financial regulatory agencies and consultation with equity and fixed-income analysts. New disclosure requirements should wait for rulings from the Securities and Exchange Commission and International

Organization of Securities Commissioners. Ultimately, we recommend that the Basel Committee, working closely with the industry and investor community, identify a subset of key disclosures that will appropriately convey an institution's risk profile without inundating the market with irrelevant and uninterruptible information. Remaining disclosures should be left to the judgment of each institution based on the demands of investors.

Conclusion

The American Bankers Association appreciates the opportunity to comment on the ANPR on a Proposed New Basel Capital Accord. U.S. banks remain concerned that the ANPR and the proposed New Accord on which it is based continue to be too prescriptive and complex. We believe that regulation should not be so detailed and inflexible so that it undermines the continuing evolution of risk management. Instead, regulation should be flexible enough to accommodate the development of financial products and risk mitigation techniques. Decisions concerning the form, structure and prioritization of risk management processes and system enhancements should be left to individual institutions. We urge the Agencies to pursue this more principles-based approach and to further reduce the level of prescription throughout the Accord. Rather than detailed Pillar 1 requirements, supervisors should establish strong guidance and outline the principles for risk management policies and practices in Pillar 1. Standards for the internal models should be unambiguous and the models should be subject to rigorous supervisory verification under Pillar 2. This will establish a nimble and risk-sensitive approach that can appropriately reflect each bank's unique risk profile and may be quickly adapted as the financial products and risk management techniques evolve. If there any questions about this comment letter, please call one of the undersigned.

Sincerely,

Paul Alan Smith

Paul Smith
Senior Counsel

Robert W. Strand

Robert Strand
Senior Economist

Attachment

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N10b
No 0602

Mr. Jaime Caruana
Chairman of the Basel Committee
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

7 July 2003

Dear Mr. Caruana,

<u>Subject</u>: The Second Pillar – Supervisory Review Process

We understand that at its next meeting, on 15 – 16 July, the Basel Committee on Banking Supervision will discuss the Second Pillar of the New Basel Capital Accord, the Supervisory Review Process.

We share the view of the Committee that the Second Pillar of the New Basel Accord will be critical in determining the impact of the new regime for individual firms and the global banking industry. We are writing to underscore the importance the global banking industry attaches to this issue, to raise concerns in respect of the clarity of policy and to contribute to what we believe is an urgently needed debate.

In its original form the purpose and scope of the Supervisory Review Process was clear. It provided a framework which affirmed that it was the responsibility of a bank to assess its own capital needs and the supervisor's role was to review and challenge this process and intervene promptly where necessary, including being able to set higher minimum capital standards for an individual bank. We broadly supported this objective and understood its value.

Industry concerns initially focused on the potential for divergence in the application of the Supervisory Review process by different national supervisors. This concern, at least in part, was grounded in very different existing national supervisory practice. However, it was accepted that the solution to this issue lay in the co-ordination and convergence of national supervisory practice rather than the introduction of a more prescriptive rule set. The later establishment of the Accord Implementation Group reflected this consensus.

We are now concerned that the original clarity of purpose and scope of Pillar 2 has become confused and that this will directly threaten prospects for the coherence of implementation. This concern is based on:

- a general blurring of the purpose of Pillar 2 and of the relationship between Pillars 1 and 2;
- and specifically the proposal in the Third Consultative Document for the introduction into the Supervisory Review Process of a series of supplementary specific risk issues (Section C, paragraphs 719 – 755).

The industry is extremely concerned that Pillar 2 is moving toward a system of automatic capital add-ons, driven less by the specific circumstance of each bank and more by a general regulatory requirement. This would be unacceptable, not least because these requirements have not been included in the calibration of the Accord.

We wish to enter into a debate with the Committee on how to deliver the original objectives of Pillar 2. As the Committee enters discussion, we would ask that the following points be considered:

1. **Capital impact.** Pillar 1 is calibrated to generally deliver an adequate regulatory capital charge and will require banks to meet high qualitative and quantitative standards. Additional capital requirements under Pillar 2 should therefore be the exception not the rule.

2. **Specific risk issues.** The introduction of specific risk issues in Section C sits awkwardly in the context of Pillar 2. These issues should be re-integrated into the general framework. Principle 1 requires the incorporation of bank-specific risks into the capital assessment, and with Pillar 1 already covers some of the issues re-opened here.

3. **Net adjustment within Pillar 2.** Any additional capital requirement should be a net adjustment within Pillar 2. That is, whilst Pillar 2 rightly focuses upon model fit, there can be no presumption that this fit is always negative. We strongly believe that a net adjustment is required where the under and overstatements of required capital produced by poor model fit are netted off. For example, the positive impact of diversification of risk should be recognised. Diversification gives grounds for a negative adjustment within Pillar 2, offsetting unmeasured risks and the results of stress testing.

4. **Level of application.** Pillar 2 should be applied at the top consolidated group level by the home supervisor. It should not be applied, except in exceptional circumstance, by host supervisors.

5. **Disclosure.** We support the Committee in proposing that no bank level disclosure, of measures required under Pillar 2, should be made.

The points above represent a common view on the major issues in Pillar 2 that need to be addressed prior to the confirmation of the new Accord. As important is the generation and confirmation of a consensus as to the scope and purpose of application of Pillar 2. As stated above we believe that this is fundamental to the objective of achieving convergence in implementation.

We would be pleased to undertake further discussion directly with the Committee if this would be helpful in furthering this debate. We will be writing separately with our general comments on the Third Consultative Document.

We are sending a copy of this letter to Mr. Nick le Pan, Deputy Chairman, Basel Committee on Banking Supervision and Chairman, Accord Implementation Group.

Yours sincerely,

Donald G. Ogilvie
President and Chief Executive Officer
American Bankers' Association

David Bell
Chief Executive
Australian Bankers' Association

Raymond J. Protti
President and Chief Executive Officer
Canadian Bankers Association

Maurizio Sella
President
European Banking Federation

Masari Ugai
Vice Chairman
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Japanese Bankers Association