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14 November 2003

By E-mail and Overnight Courier

The Financial Services Authority
c/o Katy Martin
Prudential Standards Division
25 The North Colonnade
canary Wharf
London E14 5HS

Subject: Comments on the Consultation Paper on the Implementation of the New Basel and EU Capital Adequacy Standards

Ladies and Gentlemen:

This letter is MBNA Europe Bank Limited's initial response to the Financial Services Authority's ("FSA") report and first consultation on the implementation of the Basel and EU Capital Adequacy Standards ("CP 189"). In accordance with an e-mail dated 5 November 2003 from Stephen Funnell, our line supervisor at the FSA, we will be submitting a more detailed comment, including our response to the 60 questions raised in CP 189, where appropriate, by 30 November 2003. We appreciate the opportunity to provide comment on the New Basel Capital Accord (the "New Accord" or "Basel 11") in general, as presented under the Basel Committee on Banking Supervision's (the "Committee") third consultative paper ("CP 3") and CP 189.

MBNA Europe Bank Limited is a wholly owned subsidiary of MBNA America Bank, N.A., itself the principal subsidiary of MBNA Corporation (collectively herein referred to as "MBNA"). MBNA's primary business is retail lending, providing credit cards and other retail lending products to individual consumers. At 30 September, MBNA reported assets net of securitisations totaling **$58.7** billion and managed assets, including securitised loans of $141.1 billion.

MBNA has been an active participant throughout the development process of the New Accord. We have participated in Quantitative Impact Study 3 ("QIS 3") and the operational risk loss data collection exercise in order to help the Committee measure the regulatory capital impact of Basel 11. Throughout this process, we have consistently expressed serious reservations with many aspects of the New Accord, including its overall complexity, capital distortions created by the advanced internal ratings-based ("A-IRB") approach for unsecured retail credit exposures, creation of a capital charge for operational risk, securitisation treatment, and disclosure requirements. Other than the creation of the qualifying revolving retail exposure ("QRE") formula, which recognises the importance of future margin income, very little has changed in areas important to active credit card issuers and even the QRE formula does not achieve an appropriate capital/risk balance. Although CP 189 is focused very much on implementing CP **3** "as is" (or "as was" in the light of the Madrid compromise of October **2003,** see below), we hope that our concerns will be considered fully and that an approach will develop that addresses cost, complexity, regulatory burden, and competitive impact.

We note that since the releases of CP **3** and CP **189,** the Committee announced four principal areas where significant changes to the Basel II framework are expected.[1] In its press release and the accompanying attachment, the Committee provided only a general description of how it now intends to have the New Accord treat expected and unexpected losses. It also invited interested parties to provide comment on these changes by December **31,2003.** Other than a general statement, no other information was provided. We believe that it would be helpful for the overall development effort of the New Accord for the Committee to provide additional information that more fully specifies these changes and their proposed application, as this could have a significant impact on the FSA's approach to implementing the New Accord.

Without that it will be difficult for the regulatory agencies to both collect meaningful commentary on the proposed changes and to ensure that no institution or business line is unreasonably impacted. Although we support in general the changes announced by the Committee, without additional information as to how these changes will be applied and calibrated, we are limited in our ability to evaluate fully the new proposals and provide the kind of meaningful commentary we believe these changes deserve.[2] Without knowing more, we believe that the scope of the proposed changes also suggests the need for an additional QIS prior to adoption of the final rules.

[1] The four areas are: "[1] changing the overall treatment of expected versus unexpected credit losses; [2] simplifying the treatment of asset securitisation, including eliminating the 'Supervisory Formula' and replacing it by a less complex approach; [3] revisiting the treatment of credit card commitments and related issues; and [4] revisiting the treatment of certain credit risk mitigation techniques." The Committee did not offer information concerning items 2-4, where additional changes are expected. We anticipate that further guidance will be provided for these three areas.

[2] We would welcome the opportunity to provide additional comment to the Committee and the national supervisors once they have had the opportunity to consider the proposed changes and provide appropriate regulatory guidance on how to apply these changes. We believe that this would be most appropriately accomplished through an additional round of consultation.

We support the primary goal of increasing risk sensitivity and of creating a process for better differentiating risk and assigning appropriate capital to those exposures. We remain concerned, however, that the internal ratings based approach contained in CP 3 will result in a highly prescriptive set of rules which will be costly to implement and comply with and may not achieve the desired results of a risk-sensitive framework with appropriate capital requirements across product types.

This letter addresses our general concerns with both CP 3 and the FSA's CP 189. Enclosed herein at *Appendix A* is MBNA America Bank, N.A.'s response to and comments on the advanced notice of proposed rulemaking on the implementation of the New Accord issued by the U.S. regulatory agencies. This attachment contains the specific comments and detailed analysis supporting our general CP 3 comments below.

CP 3

We have continuing concerns with CP 3 centered in four general areas: (1) the treatment of unsecured retail credit, (2) the conservative assumptions and treatment of uncommitted credit lines affecting originators in asset securitisations, (3) inclusion of a specific capital charge for operational risk, and (4) the cumulative conservatism of the assumptions contained in the overall approach.

Treatment of Retail Credit

The A-IRB approaches will significantly impact institutions with material unsecured retail exposures. The conservative capital treatment for unsecured retail exposures should not be used by the Committee to offset lower regulatory capital requirements for other asset types without understanding their relevant risks and business models. The seemingly arbitrary approach to unsecured retail lending may cause significant competitive harm. Before the New Accord is finalised, it is critical to undertake an additional QIS to ensure that the risks for unsecured retail lending are captured accurately and an appropriate capital treatment is applied that correctly measures the underlying risks of unsecured retail lending.

The Committee in presenting CP 3 has evidently ignored the substantial differences between revolving retail credit portfolios and corporate credit portfolios. Applying a corporate credit model (which is based on single credit exposures) to retail credit portfolios (which are managed as pools of individual exposures) has not been sufficiently tested or validated. 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, uncommitted/undrawn lines, asset value correlation, etc.) carry a level of complexity that merits further review and study.

Under the IRB approach, capital requirements for unsecured retail loans are higher than both the 1988 Capital Accord (the "Current Accord"), and the standardised approach of Basel 11. We believe that this result contradicts the New Accord's stated objective that the IRB approaches would result in more effective risk measurement and, therefore, lower capital requirements than the standardised approach. Our internal analysis has determined that, from a portfolio point of view, the economic risk of the A-IRB approach should be less than the CP 3 standardised approach for unsecured retail lending. As such, substantial recalibration of the A-IRB will be necessary to correct these major differences.

Banks should hold capital for unexpected losses only. Although the Committee has now announced its intention to separate the treatment of unexpected losses and expected losses, how this change will be applied requires additional clarification by the Committee and the national supervisors. We are concerned with the Committee's conclusion that expected one-year losses must be measured against the loan loss reserve and that any shortfall would be taken as a deduction of 50% from Tier 1 capital and 50% from Tier 2 capital. This approach appears to ignore completely the effect of future margin income ("FMI") as an offset to expected losses. The Committee needs to recognise the value of FMI in covering expected losses, or any shortfall between expected losses and loan loss reserves, before any deduction to capital is applied. The lack of differentiation in the treatment of FMI between retail and corporate loans is particularly onerous to unsecured retail lending, which is priced to cover higher, though more predictable, expected losses relative to corporate loans (the average probability of default ("PD") in a portfolio of unsecured retail loans is typically larger than the average PD of a portfolio of corporate loans).

The potential risk of additional draws from uncommitted retail credit lines that can be terminated at will by a lender does not warrant a charge for additional capital. The risk associated with undrawn, uncommitted lines for unsecured retail loans is very low, particularly when they are closely monitored and readily cancelable by the lender. In MBNA's case, for example, over 90% of available U.K. credit card lines are in accounts with expected PDs less than 2%.

The asset value correlation ("AVC") factors are not consistent with our own (U.S.) experience. We suggest that each institution should be permitted to establish its own AVC factors. At the very least, the Committee should lower the range of AVC factors to 2% - 5% for QREs, with a corresponding reduction for other retail exposures.

Asset Securitisation

The requirement that originators hold ***more*** capital than investors for similar risk exposures is overly conservative and unnecessary. We believe that originators should not be burdened with higher capital requirements compared to investors in equivalent risk positions, Undrawn, uncommitted credit lines related to revolving accounts included in securitisation transactions should not require capital. In typical revolving securitisation structures, both current drawn balances and future Customer draws, are securitised. During the revolving period, investors do not have the ability to choose whether or not to purchase newly originated loans, nor do they have the ability to purchase only low-risk receivables. Rather, investors are required to purchase receivables, on a pro-rata basis, from all accounts in the securitisation vehicle. If the Committee is trying to allocate capital for the risk of amortisation, that risk is already captured through the proposed new early amortisation capital requirement.

Operational Risk

Operational risk management is an emerging discipline; the current state-of-the-art practices for operational risk measurement are still in their very early stages. As such, we question the wisdom of a specific capital charge for operational risk at this time. We see little harm in waiting to apply any change as an interim step since most larger banks have more than adequate capital in place to cover both credit risk and cushion against operational risks. It is imperative that banks be given adequate time to evolve their operational risk measurement practices before any capital charge for operational risk goes into effect.

Consistent with our recommendation for credit risk and with the Committee's decision to rely solely on unexpected losses for the measurement of risk-weighted assets, any application of operational risk capital charge must be limited to unexpected losses, and not include expected losses, including, for example, credit card fraud losses.

Direct calculation of specific risk results to a 99.9% confidence level, with a verifiable degree of accuracy, will not be possible for most business lines given the lack of available data or will result in an extremely conservative capital charge, which would not make economic sense for the institution.

Cumulative Conservatism

We recognise the need to incorporate a level of conservatism to ensure that the risk being undertaken is appropriately captured. However, we are very concerned that the cumulative effect of these decisions result in Pillar 1 capital requirements that no longer reflect minimum regulatory levels. Examples are the need to use risk parameters that reflect the worst part of the business cycle (i.e., hold additional capital) in order to protect against procyclicality, capital charge on credit lines that are uncommitted and cancelable, asset correlation assumptions that are higher than industry averages, not enough recognition of the value of future margin income for unsecured retail lending, etc.

CP 189

We are generally supportive of the FSA's overall approach and the proposed exercise of discretions. However, we have three fundamental concerns with CP **189: (1)** development of detailed implementation requirements prior to final adoption, (2) the implementation timetable itself, and (3) the proposed requirement that firms using the standardised approach hold the greater of capital under the standardised approach or the IRB approach. These concerns are addressed below.

Development of detailed implementation requirements prior to final adoption

CP **189** is centered upon the actual implementation components of and requirements for qualification under the advanced approaches. It appears to assume that the New Accord will be adopted "as is" or only as directed by the European Commission or the Committee and that input regarding needed changes to the New Accord will not be considered or pursued by the FSA. This appears to be true even though the New Accord has neither been formally adopted by the Committee nor approved by the appropriate supervisory or legislative authorities of each country. We are concerned that the FSA may have predetermined the result of the final form of the New Accord, without fully considering the views of affected institutions – thus calling into question the soundness of the entire process. We believe that the FSA should work to finalise the accord, considering fully the concerns raised by the institutions they regulate, before embarking upon an implementation plan.

Implementation timetable

We remain concerned that the implementation timetable established by the Committee and supported by the FSA may not consider the vigorous debate underway regarding critical elements of the New Accord, particularly the retail lending segment. We continue to believe that before deadlines can be established and before institutions must be required to make the changes to conform to the requirements of the New Accord, final adoption is necessary by the appropriate supervisory and legislative authorities is necessary. Moreover, given the recent changes announced by the Committee and the significant concerns raised (by both major financial institutions and governments, particularly the U.S. Congress[3]), regarding the overall direction of the New Accord, principally with respect to complexity, expense, and regulatory burden, we believe that it may be premature to embark upon an expensive and detailed effort to meet the current requirements of the New Accord, when those requirements may change in the future. Based on the foregoing we believe that the FSA must remain flexible about the implementation date and the dates in which financial institutions must achieve certain milestones.

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[3] See **Letter from the U.S House of Representatives Committee on Financial Services Comments to the U.S. Banking Regulators** on **the Advanced Notice of Proposed Rulemaking** on **the Proposed Revisions of the Basel Capital Accord (Nov. 3,2003) (enclosed herein at** *Appendix B*).

Additional capital requirements where applying the IRB approach produces a higher capital charge for banks using the standardised approach

The FSA is considering whether to impose an additional capital requirement for firms using the standardised approach if their Pillar 1 capital requirement is less than it would be under the IRB. We believe that this proposal ignores the underlying faults in parts of the IRB approach and creates a construct that may grant bank examiners too much subjective discretion in determining the "appropriate" amount of capital.

Assuming that the Committee has correctly calibrated the capital requirements under the standardised and the IRB approaches, there should be little difference between the two. However, as MBNA America has noted in both its comments on CP 3 and on the U.S. Agencies' advanced notice of proposed rulemaking, there remain significant deficiencies with the IRB treatment of unsecured retail credit.[4] MBNA America's experience reveals that the capital requirements for credit card loans under the A-IRB approach are significantly higher than under either under the Current Accord or the standardised approach. Moreover, from an economic risk perspective the standardised approach is more closely aligned with its own internal models. Rather than penalising banks that recognise that the standardised approach is more consistent with their own measure of risk, we believe that the FSA and the Committee should work to correct the deficiencies of the A-IRB approach for unsecured retail lending.

For firms that are adopting the standardised approach for all of their exposures, the FSA recognises that it would be unwise for them to estimate the risk characteristics in their portfolios – recognising the practical difficulties firms would face applying a framework they do not use to develop these estimates. In response the FSA suggests an approach, that asks firms to consider the credit risk they are exposed to and the FSA would thereafter use this as a basis for making adjustments to the amount of capital they hold under Pillar 2. This approach appears to be entirely open-ended and result-driven, without any objective standards to apply. As noted, we believe that the Committee must ensure that the underlying assumptions for the A-IRB approach for unsecured retail lending are correct and that the treatment for these exposures reflects fairly the risks that are at stake.

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[4] See MBNA's Comments to Advanced Notice of Proposed Rulemaking on the Implementation of the New Basel Capital Accord, at p. 13 (Nov. 3,2003) (enclosed herein at *Appendix A*).

We appreciate the opportunity to provide these comments to the FSA. If you have any questions regarding this submission or if we can provide further information, please contact Vernon Wright directly by telephone at **001-302-453-2074** or by e-mail at vernon.wright@mbna.com.

Yours truly,

Vernon H.C. Wright	Robin L. D. Russell	Kenneth F. Boehl
Chief Financial Officer	Chief Corporate Finance Officer	Corporate **Risk** Officer
MBNA Corporation	MBNA Europe Bank Ltd.	MBNA Corporation

Enclosures:

Appendix A – MBNA's Comments to Advanced Notice of Proposed Rulemaking on the Implementation **of** the 'New Basel Capital Accord (Nov. **3,2003).**

Appendix B – Letter from the **U.S.** House of Representatives Committee on Financial Services Comments to the U.S. Banking Regulators on the Advanced Notice of Proposed Rulemaking on the Proposed Revisions **of** the Basel Capital Accord (Nov. **3,2003)**

C:
Stephen Funnell, The Financial Services Authority
The Basel Committee on Banking Supervision
The European Commission
Office of the Comptroller **of** the Currency (U.S.)
Board of Governors of the Federal Reserve System (U.S.)
Federal Deposit Insurance Corporation (U.S.)
Office of Thrift Supervision (U.S.)
Office **of** the Superintendent of Financial Institutions (Canada)
Irish Financial Services Regulatory Authority
Banco de España

Appendix A

MBNA America Bank, N.A.'s Response to and Comments on the Agencies'
Advanced Notice of Proposed Rulemaking
On the Implementation **of** the New Basel Capital Accord
November 3,2003

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MBNA America Bank, N.A.'s Response to and Comments on the Agencies' Advanced Notice of Proposed Rulemaking On the Implementation of the New Basel Capital Accord[1]

November 3,2003

I. Executive Summary (p. 45901)

A. *Introduction* (p. *45901)*

General Comments:

We appreciate the Agencies' objective to develop more risk-sensitive capital requirements, but continue to have serious reservations about many technical aspects of the new Basel Accord (the "New Accord" or "Basel 11")as well as the proposed U.S. implementation strategy. Given the Agencies' view on how the New Accord will apply and who will be affected, we question whether making the dramatic changes envisioned will ultimately achieve truly risk-sensitive capital requirements. We note that one of the Agencies' goals, while developing and implementing a final New Accord, is to ensure that the aggregate capital requirements for the U.S. banking system remain essentially unchanged. Although the Agencies expect that some institutions may face increases or decreases in their minimum risk-based capital requirements, the Agencies also insist that the systemic or overall capital levels in the U.S. banking system will remain constant. The Agencies have also concluded that the advanced approaches of the New Accord will apply only to ten banks on a mandatory basis ("core banks"). Certain core banks believe that they will be rewarded with lower capital requirements because of their lower risk exposures. "Opt-in banks" will only choose the advanced approach if they conclude that they will be rewarded with favorable capital treatment. Additionally, all other banks will continue to report based on the **1988** Capital Accord (the "Current Accord") which should not change the amount of regulatory capital. We wonder how the Agencies will be able to meet their seemingly conflicting objectives of unchanged systemic capital levels and greater risk sensitivity, while also meeting the expectations of large banks to have lower capital requirements.

Although the Current Accord has its weaknesses, its ftamework by comparison is straightforward and understandable. In the U.S., it has served as a satisfactory ftamework for ensuring that adequate regulatory capital remains in the U.S. banking system. In fact, as currently proposed, it will continue to determine how regulatory capital is calculated for the vast majority of U.S. banks. Moreover, many of the improvements envisioned in the New Accord, such as increasing transparency, implementing better risk management practices, and developing more accurate risk measurement techniques, will still be achieved through the regulatory/supervisory process, even without the complexity and burden the

[1] Provided herein, MBNA addresses each of the questions or requests for comment we found applicable to the company or to our industry. For clarity, we also included both the original captioned headings in the advanced notice of proposed rulemaking ("ANPR") and every specific question seeking public comment, appending the ***Federal Register*** page numbers, regardless of whether we submitted a response. We also numbered each question presented in the ANPR in order to assist in cross-referencing our other responses to the Agencies' questions. Included with our responses to the specific questions, are also general comments adjacent to the ANPR captioned headings that address additional issues, not raised as matters requesting comment by the Agencies.

current draft imposes[2] The increased regulatory burden, the significant financial cost, the small number of institutions directly affected by the change, and the minor changes to risk-based capital in the U.S. banking system makes us question the wisdom of abandoning the Current Accord for the approach envisioned by the ANPR and the New Accord.

B. *Overview of New Accord (p.* **45901)**

C. *Overview of U.S. Implementation (p.* **45902)**

The A-IRB Approach for Credit Risk (p. 45902)

Wholesale (Corporate, Interbank, and Sovereign) Exposures (p. 45902)

Retail Exposures (p. 45903)

Equity Exposures (p. 45903)

Securitization Exposures (p. 45903)

Purchased Receivables (p. 45903)

The AMA for Operational Risk (p. 45904)

Other Considerations (p. 45904)

Boundary Issues (p. 45904)

Supervisory Considerations (p. 45904)

Supervisory Review (p. 45904)

Disclosure (p. 45905)

D. *Competitive Considerations (p.* **45905)**

1. *What are commenters' views on the relative pros and cons of a bifurcated regulatory capital framework versus a single capital regulatory framework? Would a bifurcated approach lead to an increase in industry consolidation? Why or why not? What are the competitive implications for community and mid-size regional banks? Would institutions outside of the core group be compelled for competitive reasons to opt-in to the advanced approaches? Under what circumstances might this occur and what are the implications? What are the competitive implications of continuing to operate under a regulatory capital framework that is not risk sensitive? (p. 45906)*

Response:

Without further study it is unclear what the competitive impact would be if a bifurcated framework were ultimately adopted. While smaller institutions will remain under the Current Accord and would not be required to adopt an internal ratings-based ("IRB") approach for assessing capital, and thus not incur the significant investment of resources needed, these banks would also not receive the benefits, if *any,* of a more risk-sensitive approach. Conversely, while core banks would be required to adopt the advanced-IRB ("A-IRB") approach and the advanced measurement approach ("AMA") for operational risk, where their smaller competitors would not, there remains no reasonable assurance that the New Accord will ultimately provide lower overall costs (either in capital or expense) to these larger institutions. Further study is needed to fully understand the true impact that the proposed changes will have on both large and small institutions.

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2 The Agencies recognize this as they continue to make changes to risk-based capital treatment to more appropriately reflect the risks faced by financial institutions. See e.g., Press Release, "Agencies Issue Rulemakings to Amend Risk-Based Capital Treatment of Exposures to Asset-Backed Commercial Paper Programs and Securitizations with Early Amortization Provisions," interim rule (Sept. 12,2003).

As a matter of public policy, we question whether institutions should be held to different capital frameworks and standards when determining capital adequacy. Why should the strength of a bank's capital position be determined solely upon the framework it chooses to apply? Under this proposed bifurcated regulatory construct, a bank could be considered "well capitalized" under the Current Accord and considered only "adequately capitalized" as measured by the New Accord, or vice versa, thereby leading to a form of unintended regulatory arbitrage.

If an ultimate goal of the New Accord is to promote stability in the banking system by ensuring that banks hold sufficient capital against underlying risks, we believe that the standards and the way capital adequacy is measured should remain consistent *for all* institutions operating in the U.S. banking system, and indeed worldwide. Accordingly, we would recommend that, for whatever framework is ultimately adopted by U.S. regulators, that framework should apply to all banks. This approach would require the Basel Supervisors Committee (the "Committee") to reconsider the overall complexity and burden of the New Accord and develop instead an approach that in fact facilitates a more risk-sensitive and efficient approach to allocating regulatory capital and that can be applied to all institutions.

2. *If regulatory minimum capital requirements declined under the advanced approaches, would the dollar amount of capital held by advanced approach banking organizations also be expected to decline? To the extent that advanced approach institutions have lower capital charges on certain assets, how probable and significant are concerns that those institutions would realize competitive benefits in terms of pricing credit, enhanced returns on equity, and potentially higher risk-based capital ratios? To what extent do similar effects already exist under the current general risk-based capital rules (for example, through securitization or other techniques that lower relative capital charges on particular assets for only some institutions)? If they do exist now, what is the evidence of competitive harm? (p. 45906)*

N/A

3. *Apart from the approaches described in this ANPR, are there other regulatory capital approaches that are capable of ameliorating competitive concerns while at the same time achieving the goal of better matching regulatory capital to economic risks? Are there specific modifications to the proposed approaches or to the general risk-based capital rules that the Agencies should consider?* **(p. 45906)**

Response:

Rather than creating a new capital accord that is considered by many to be inordinately complex, burdensome, and costly (with questionable value to shareholders and other market participants), we would suggest a simpler and more uniform approach to regulatory capital calculation. We believe that the general construct as presented in the New Accord's simpler approaches to credit and operational risk (such as the alternative standardized and basic indicator approaches, collectively referred to herein as "standardized approaches") would be a better place to start. With appropriate changes and validation, these standardized approaches in Basel II would address some of the shortcomings of the Current Accord, while limiting the burden institutions would face in otherwise complying with the advanced approaches. This march towards a complete change in the way banks are managed and supervised, as envisioned by the advanced approaches, is ironic particularly given both Chairman

Greenspan's faith in the continued strength in the U.S. banking system[3] and the OCC's positive outlook regarding the health and the strong capital position of banks in the national banking system! We strongly believe that a less draconian approach should be considered and that the Committee, with the urging of U.S. regulatory agencies, should reevaluate their overall approach to Basel II and develop a simpler system more in line with the standardized approaches in the New Accord that can be applied to all banks.

11. Application of the Advanced Approaches in the United States (p. 45906)

A. *Threshold Criteria for Mandatory Advanced Approach Organizations* (p. 45906)

General Comments:

In the ANPR, the Agencies have determined that the large, internationally active banks will be required to adopt the A-IRB and AMA. The test for determining mandatory application is whether the institution has assets of $250 billion or more or total on-balance-sheet foreign exposures of $10 billion or more. Either condition would require adoption of the advanced approaches.

The Agencies have not explained this decision; nor have they invited public comment.

At the outset, we believe that mandatory application of the advanced approaches is counter to a basic premise of Basel II – banks should be permitted to choose "between two broad methodologies for calculating capital requirements" (the standardized approach or the IRB approach). See e.g., The New Basel Accord, Consultative Document 3, Basel Committee on Banking Supervision (April 2003) ("CP 3") at ¶ 24. In fact the Committee makes plain that in order to qualify for the advanced approaches, banks must meet certain conditions or remain under the standardized approaches. See e.g., CP 3 at ¶ 180,

We further believe that the threshold establishing the class of core banks is arbitrary. While $250 billion in assets by any definition represents a large pool of assets, we find it inexplicable to conclude that $10 billion in foreign exposures creates an equivalent condition that warrants Basel II advanced approaches application. The absence of data to explain this determination makes us question the soundness of the methodology used to draw those lines.

As a bank with foreign operations in the U.K., Canada, Ireland, and Spain, MBNA's foreign exposures, although greater than $10 billion, do not currently represent a major part of our overall business. Moreover, consideration of foreign exposures must extend beyond a simple number in a regulatory report, to include an analysis of the nature of those foreign exposures. For example, MBNA's foreign exposures are not concentrated in our primary business line, retail lending. At year-end 2002, MBNA's 10-K reported total foreign assets of $12.7 billion with foreign loan exposures of

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[3] Despite "a sharp run-up in corporate bond defaults, business failures, and investor losses. At commercial banks, troubled loans – including charge-offs, classified loans, and delinquent credits – have also climbed to quite high levels. At the same time, banks in this country remain quite healthy – with strong profits and rates of return and with capital and reserves not much below recent historical highs." Remarks of Alan Greenspan, Chairman of the Board of Governors of the U.S. Federal Reserve System at the annual convention of the American Bankers Association, Phoenix Arizona (Oct. 7,2002).

[4] "The national banking system remains healthy and has enjoyed strong earnings growth over the last several years, despite the global economic slowdown. Banks have used part of their additional earnings to further strengthen capital, which has now reached record levels." OCC Strategic Plan, Fiscal Year 2003 – 2008.

$6.8 **billion.**[5] The $5.9 billion remaining foreign exposures are principally part of a "well diversified" liquidity/investment portfolio and, we believe, should be excluded from any analysis meant to determine the significance of our international competitive presence. At a minimum, the Agencies must focus on markets where material competition among institutions exists.

If not for the existence of our foreign exposures, MBNA clearly would not be among the mandatory institutions. We note that many of our U.S. competitors with a smaller international presence will not be governed by these rules, yet they remain active in those markets. We note also that many of our foreign competitors in these international markets will not be required to apply the advanced approaches, but may be permitted to apply the less burdensome and less costly standardized approaches. Under CP 3, most retail banks m the unsecured lending business will receive far less favorable treatment under the advanced approaches than under the simpler standardized approaches. The Agencies' decision to establish an international cutoff of $10 billion creates real and significant cost for MBNA, yet no rule of reason is proffered that supports the distinction made. We find the cutoff arbitrary particularly when applied to an institution that has a limited range of retail products and is not exposed to the wide and varied risks that a typical large commercial bank confronts.

If the underlying purpose for both the Current Accord and the New Accord is to establish a capital measurement framework that will foster international consistency, and if the Agencies remain committed to establishing a mandatory group of core banks, we recommend that the definition of core banks should change to either:

a. Banks that are both large and internationally active, or
b. Banks that are either large or have an international presence and compete in those markets, without regard to the size of their foreign operations (subject to a de minimis exception as envisioned in CP 3).

Banks should be permitted to choose the methodology that makes the most sense for their organization. At the very least, the group of mandatory core banks should be defined so that it: (a) minimizes the competitive harm to any one particular institution; (b) places similar institutions on equal footing; and (c) is supported by a rule of reason.

Application of Advanced Approaches at Individual Bank/Thrift Levels (p. 45906)
U.S. Banking Subsidiaries of Foreign Banking Organizations (p. 45906)

4. ***The Agencies are interested in comment on the extent to which alternative approaches to regulatory capital that are implemented across national boundaries might create burdensome implementation costs for the U.S. subsidiaries of foreign banks.*** **(p. 45907)**

<u>**N/A**</u>

B. Implementation for the Advanced Approach Organizations **(p. 45907)**

C. Other Considerations

General Banks (p. 45907)

[5] These numbers are consistent with MBNA's FFIEC 009 report, but will vary slightly due to certain minor reporting differences.

5. *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. (p.* 45907)

Response:

See response to Question No. 3, above. By changing the way capital is calculated for all banks and by focusing on an approach that is reasonable in scope, appropriate in total cost, and adequately risk-sensitive, all banks will remain on equal footing with respect to regulatory burden and the way capital is calculated.

Majority-Owned or Controlled Subsidiaries (p. 45907)

6. *The Federal Reserve specifically seeks comment on the appropriate regulatory capital treatment for investments by bank holding companies in insurance underwriting subsidiaries as well as other nonbank subsidiaries that are subject to minimum regulatory capital requirements. (p.* 45908)

N/A

Transitional Arrangements (p. 45908)

7. *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. (p.* 45908)

Response:

See response to Question No. 8, below.

8. *Do the projected dates provide an adequate timeframe for core banks to be ready to implement the advanced approaches? What other options should the Agencies consider? (p.* 45908)

Response:

In general, we believe that the timelines established in CP 3 and the ANPR are unrealistically ambitious given the extensive work that must be completed by affected institutions to meet the advanced approaches in the New Accord. In addition to required systems development and technology changes and the collection of operational loss and other data, institutions will require the necessary time to hire, develop and train qualified people to support this new framework. Given the significant changes envisioned by the New Accord, bank regulatory agencies will also require substantial time to meet these new demands. Moreover, if the effective target date is January 1,2007 (or year-end 2006 as stated in CP 3) and institutions are required to demonstrate three years of compliance before implementation, then a mandatory institution must be compliant by the end of this year. This is impractical, particularly since the New Accord currently remains in draft form and the OCC "will not begin implementing a final revision to the Basel capital framework until [it has] fully considered all comments received and conducted whatever cost-benefit and impact analyses are required[.]" See *Press Release,* Comptroller of the Currency Administrator of National Banks, "Bank and Thrift Agencies to Seek Comment **On** Proposals for U.S. Implementation of Basel II" (July 11,2003). Given the foregoing and given that there remains a number of outstanding issues relating to calibration of credit risk, the calculation of operational risk, and stress testing requirements, we believe that the established timelines must change.

As opposed to the hard stop dates established in the New Accord, we recommend that the transitional arrangements and timelines should be established through the supervisory process. Each institution, depending upon its complexity, size, current practices, diversity of business lines, and geographic areas will have its unique set of challenges in assembling the necessary data and infrastructure to support the advanced approaches. As noted in the ANPR, the Agencies must be fully satisfied "that the institution's systems are sound and accurately assess risk and that resulting capital levels are prudent." ANPR, Fed. Reg, at **45908.** The Agencies should allow the supervisory process to operate, and timelines should be established only after each institution and its primary regulator understand the scope of work and the time needed to complete it.

As an alternative, if the Agencies believe that a specific date must be established for implementation of the advanced approaches, we would suggest an acceptable time period after from the date of adoption by the U.S. regulators rather than January 1,2007. Specifically, we recommend that mandatory banks should have five years from the date of final adoption of the New Accord to assemble the necessary operational risk data, develop the systems and infrastructure to support the advanced approaches, and receive approval from their primary Federal regulator. The timeline would begin with adoption of the final rule and be as follows:

- one year to develop and build the data collection systems
- three years of historical data
- one year parallel reporting

Under all scenarios, however, it is critical that U.S. and European regulators operate under the same timeline.

9. *The Agencies seek comment on appropriate thresholds for determining whether a portfolio, business line, or geographic exposure would be material. Considerations should include relative asset size, percentages of capital, and associated levels of risk for a given portfolio, business line, or geographic region.* (p. 45908)

Response:

We recognize that Basel II requires the A-IRB approach, once adopted, to be used across all material business lines, portfolios, and geographic regions. We appreciate that a provision has been written into the New Accord giving the supervisor authority to exempt certain non-significant business units and asset classes from the advanced approaches for organizations reporting under the A-IRB approaches. We firmly believe, however, that no bank should be ***required*** to adopt the A-IRB approaches.

For exposures that are not material and not part of a bank's core business, we would support mapping the IRB risk inputs to the ratings generated by external credit rating agencies. This would simplify the evaluation of the exposures that are not part of a bank's principal business. A separate threshold would need to be established to determine what assets would qualify for this exception.

However, we oppose any arbitrary threshold percentage to determine materiality. The supervisor should be granted the authority to make a determination of materiality based upon first-hand knowledge of the institution and the historical trends management has relied on to protect the bank's liquidity. Institutions should be evaluated on a case-by-case basis, by the supervisor in determining whether to exempt a portfolio, business line, or geographic region from the A-IRB approach.

For example, MBNA maintains a liquidity portfolio sufficient to cover our unsecured purchased funds, retail loan growth, and securitizations. This liquid asset portfolio takes two forms, a money market component, and an investment securities portfolio. At year-end 2002, this total liquid asset portfolio represented 17.9% of balance sheet assets. The money market assets, essentially cash placed with other financial institutions in the form of Fed Funds sold, Eurodollar placements, term placements and interest-earning time deposits, are very low risk investments. In fact, MBNA has never experienced a default. Imposing the A- IRB approach for liquid assets with short time duration would be unnecessary and excessively burdensome.

MBNA's investment securities portfolio primarily consists of U.S. Treasury and U.S. Agency securities and U.K. Gilts. Current risk weights are 0% for Treasuries and Gilts and 20% for Agencies. Again, these are very low risk investments held for liquidity purposes. The balance of the investment portfolio is made up of "AAA" rated ABS securities and a small portfolio of municipal bonds and commercial CDs. Imposing the IRB formula to these assets also does not add value to the process of measuring the risk of MBNA's core business of retail lending and therefore is unnecessary.

Article 50 of the European Commission's Third Consultation Paper suggests an approach that we recommend the Agencies adopt, with one modification. The European Commission states: "Institutions applying the IRB Approach for other asset classes can apply the Standardised Approach permanently for exposures to institutions and sovereign exposures, if they have a limited number of counterparties in these asset classes, subject to approval of the competent authorities." ***Review of Capital Requirements for Banks and Investment Firms,*** Commission Services Third Consultative Paper, (July **1, 2003**)("*CAD 3*"). We would modify this approach by deleting the reference to permanent. Institutions may choose to use the standardized approach for limited counterparties due to cost reasons. At some point, the institution may decide to invest the resources to adopt the A-IRB approach and should have the option to do so.

III. Advanced Internal Ratings-Based (A-IRB) Approach (p. 45908)

A. Conceptual Overview (p. 45908)

General Comments:

We seriously question the overall workability of applying the advanced approaches in a real-time environment. Although considered by many to be a better method for assessing risk and calculating regulatory risk-based capital, this approach has never been tested beyond a quantitative laboratory. We wonder whether institutions and supervisory staffs can effectively and efficiently perform the functions envisioned by this approach in a real time environment, particularly for large, complex and diverse organizations. For this reason, we strongly support the idea of applying a more manageable approach to the calculation of regulatory capital.

Expected Losses Versus Unexpected Losses (p. 45909)

10. The Agencies seek comment on the conceptual basis of the A-IRB approach, including all of the aspects just described. 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)? The Agencies also encourage

comment on the extent to which the necessary conditions of the conceptual justification for the A-IRB approach are reasonably met, and if not, what adjustments or alternative approach would be warranted. (p. 45911)

Response:

Retail Credit

We generally agree with the concept that losses in a retail portfolio can be represented by a probability density function ("PDF") of possible losses and that this PDF can then be used to specify a required level of capital based on a stated confidence level. The calculation of required capital for credit risk is more risk sensitive than the Current Accord and may be consistent with the internal models that some banks have been developing.

Our principal concern, however, is whether enough time has been given to develop a proper framework that suits the specific features of unsecured retail lending. This is particularly true given the recent pronouncement by the Committee regarding the UL-only calibration. While we understand the theoretical direction of the Agencies, we have a number of practical concerns with certain aspects of the retail credit model, particularly with respect to the appropriate calibration of the model. Given these concerns it would be inappropriate to require banks to adopt the A-IRB approaches until these are addressed.

The basis for the retail A-IRB approach is the commercial loan credit model, which evaluates the risk for each of the individual exposures and has undergone sufficient scrutiny and rigor by the banking industry over many years. To our knowledge, applying a model based on individual exposures to a retail credit framework based on pools of exposures has not been sufficiently tested or validated by the industry. In fact, although several U.S. banks have developed and adopted internal economic capital allocation models for their retail loan portfolios, we are not aware of any widely accepted standards similar to the commercial loan model. We believe strongly that the credit framework ultimately adopted for retail loans should not simply be a modified version of the commercial model. The unique attributes to the retail framework (definition of default, portfolio segmentation, predictable expected losses, loans priced to cover expected losses, undrawn lines, asset correlation, etc.) carry a level of complexity that merits further review.

The Agencies, in working with major retail lenders, must design and conduct a comprehensive test to validate all of the variables hard-coded into the model, even before the next Quantitative Impact Study ("QIS") is conducted. Specifically, the Agencies must evaluate:

- The applicable asset value correlation ("AVC") range for the qualifying revolving retail exposures ("QRE") and other retail subcategories
  - The AVC proposed by CP 3 is far too high for the low probability of default ("PD") loans. It penalizes banks that have a higher concentration of lower risk Customers.

- The appropriate FMI credit for unsecured retail exposures where FMI can be demonstrated to cover expected losses ("EL").
  - The FMI credit for the QRE sub-category was reduced by the Committee from 90% to 75%, without providing empirical data to support the change.
  - The Committee appears to have also eliminated FMI credit, ignoring the principle that unsecured retail products, whether revolving or not, are priced to account for future losses.

- The appropriate capital charge, if any, for undrawn lines in the QRE sub-category
  - The capital charge for the risk to additional drawings for the QRE sub-category cannot be calculated by applying a simple percentage to the undrawn lines.

Alternatively, the Agencies should allow the use of internal models to determine appropriate risk factors and capital requirements.

11. *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? If the framework were recalibrated solely to UL, modifications to the rest of the A-IRB framework would be required. The Agencies seek commenters' views on issues that would arise as a result of such recalibration.* (p. 45911)

__Response:__

We agree with a UL-only framework and that this framework would be more closely aligned with internal capital allocation techniques used by large institutions.

We object, however, to any requirement that EL greater than the established loss reserve must be taken from capital. The recent change proposed by the Committee now requires that capital will be held for UL only, and EL will be covered by loan loss provisions. This new proposal calls for banks to separately calculate their EL, and if the EL is greater than the bank's loan loss provisions, it must hold capital for the "shortfall" in the provision. The New Accord has hard-coded EL as losses that are expected to be recognized over the subsequent twelve months. Such an approach conflicts with both generally accepted accounting principles in the U.S. ("U.S. GAAP")[6] and U.S. regulatory policy.[7]

For unsecured retail lending, particularly revolving lending, it is not uncommon for a loss reserve to be less than one year. This is because for many retail loans the average life of the outstanding balance is less than one year. By establishing a specific time frame in which to calculate EL, the Committee has created a fundamental disconnect between the concept of expected losses for U.S. GAAP purposes versus that for Basel II regulatory capital purposes. We can see no logical reason why the definition of expected losses under regulatory capital guidance should be different from that under U.S. GAAP. The adoption of such a change will represent a fundamental shift in current U.S. regulatory guidance on loan loss allowances for unsecured retail lending. Moreover, the adoption of this approach by Basel will put it at odds with

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[6] The guidance for establishing a reserve for loan losses is addressed in U.S. GAAP under FASB Statement Nos. 5 and 114. Under U.S. GAAP a loss must be recognized when it is probable that such a loss has been incurred and the amount of the loss can be reasonably estimated. While this targets expected losses only, U.S. GAAP limits recognition of expected losses to those inherent in the asset balance as of the balance sheet date. This is known as an "incurred loss" model: loss recognition is appropriate only to the extent to which it is probable that the loss has been incurred as of the balance sheet date. This approach conflicts with any model that is limited to a specific time period of future losses – such as one which encompasses losses that are expected to be recognized over the subsequent twelve-month period – because such a model would include losses on loans which have not yet been made or, conversely, omit losses on existing loans that may not be recognized within the next 12 months.

[7] In 1995 and 1996, the U.S. banking agencies adopted interagency guidelines establishing standards for safety and soundness, pursuant to Section 39 of the Federal Deposit Insurance Act. Those guidelines instruct institutions to conduct periodic asset quality reviews to identify problem assets, to estimate the inherent losses in those assets and to establish reserves that are sufficient to absorb estimated losses. The interagency policy statement issued July 6, 2001, in concert with the SEC's issuance of Staff Accounting Bulletin No. 102 clarifies that for financial reporting purposes, including regulatory reporting, the loan loss reserves must be determined in accordance with U.S. GAAP. Moreover, in the *Comptroller's Handbook*, the OCC, specifically notes that the "[c]overage periods of less than one year are usually associated with pools of consumer installment or credit card loans, where the OCC's classification policies require charge off at 120 days and 180 days respectively." *Comptroller's Handbook*, "Allowance for Loan and Lease Losses," at p. 14 (June 1996). Absent unusual circumstances, "most banks should be able to demonstrate that something less than 12 months coverage is adequate for such pools." __Id.__

allowance guidance issued by the International Accounting Standards Board, which **also** requires the use of an "incurred loss" model.

We further object to any framework which ignores that for unsecured retail lending, whether revolving or not, these products are priced **so** that FMI covers EL. Whenever banks can demonstrate that FMI covers EL there should never be an EL capital requirement. Basel II capital requirements should be based strictly on UL. If the Agencies insist on incorporating any test to quantify EL coverage, and any possible shortfall from the difference between EL and loss provisions, then that test needs to fully consider the benefits of FMI, including the ability to reprice those exposures.

B. *A-IRB Calculations* (p. 45911)
Wholesale Exposures: Definitions and Inputs (p. 45911)
Probability of Default (p. 45911)
Loss Given Default (p. 45911)
Exposure at Default (p. 45912)
Definition of Default and Loss (p. 45912)
Maturity (p. 45912)

12. *The Agencies seek comment on the proposed definition of wholesale exposures and on the proposed inputs to the wholesale A-IRB capital formulas. What are views on the proposed definitions of default, **PD,** LGD, EAD, and M? Are there specific issues with the standards for the quantification of **PD,** LGD, EAD, or M on which the Agencies should focus?* (p. **45912)**

<u>**N/A**</u>

Wholesale Exposures: Formulas (p. 45912)
Asset Correlation (p. 45912)
Maturity Adjustment (p. 45913)
SME Adjustment (p. 45913)

13. *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)? (p.* **45914)**

<u>**N/A**</u>

14. *Does the proposed borrower size adjustment add a meaningful element of risk sensitivity sufficient to balance the costs associated with its computation? The Agencies are interested in comments on whether it is necessary to include an SME adjustment in the A-IRB approach. Data supporting views is encouraged.* (p. **45914)**

<u>**N/A**</u>

Wholesale Exposures: Other Considerations (p. 45914)
Specialized Lending (p. 45914)

15. *The Agencies invite comment on ways to deal with cyclicality in LGDs. How can risk sensitivity be achieved without creating undue burden?* **(p.** 45915:**)**

N/A

16. *The Agencies invite comment on the merits of the SSC approach in the United States. The Agencies also invite comment on the specific slotting criteria and associated risk weights that should be used by organizations to map their internal rating grades to supervisory rating grades* ***if*** *the SSC approach were to be adopted in the United States.* **(p.** 45915**)**

N/A

17. *The Agencies invite the submission of empirical evidence regarding the (relative or absolute) asset correlations characterizing portfolios of ADC loans, as well as comments regarding the circumstances under which such loans would appropriately be categorized as HVCRE.* **(p.** 45916**)**

N/A

18. *The Agencies also invite comment on the appropriateness of exempting from the high asset correlation category ADC loans with substantial equity or that are pre-sold or sufficiently pre-leased. The Agencies invite comment on what standard should be used in determining whether a property is sufficiently pre-leased when prevailing occupancy rates are unusually low.* **(p.** 45916**)**

N/A

19. *The Agencies invite comment on whether high asset-correlation treatment for one-* **to** *four-family residential construction loans is appropriate, or whether they should be included in the low-asset-correlation category. In cases where loans finance the construction of a subdivision or other group of houses, some of which are pre-sold while others are not, the Agencies invite comment regarding how the "pre-sold" exception should be interpreted.* **(p.** 45916**)**

N/A

20. *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 risk weight function for all CRE is considered, what would be the appropriate asset correlation to employ?* **(p.** 45916**)**

N/A

Lease Financing (p. 45916)

21. *The Agencies are seeking comment on the wholesale A-IRB capital formulas and the resulting capital requirements. Would this approach provide a meaningful and appropriate increase in risk sensitivity in the sense that the results are consistent with alternative assessments of the credit risks associated with such exposures or the capital needed to support them? If not, where are there material inconsistencies?* **(p. 45916)**

N/A

22. *Does the proposed A-IRB maturity adjustment appropriately address the risk differences between loans with differing maturities?* **(p. 45916)**

N/A

Retail Exposures: Definitions and Inputs (p. 45916)

General Comments:

Ironically, the New Accord requires a substantially higher capital requirement for QREs under the A-IRB approach than under either the standardized approach or the Current Accord. An internal analysis of our U.S. credit card portfolio (see MBNA's AVC analysis and recommended factors in our general discussion of QREs at pp. 19-20, below) suggests lower AVC factors than currently proposed in the New Accord. This analysis supports the conclusion that the economic risk related to QREs would be less than the **75%** risk weighting specified under the CP 3 standardized approach for unsecured retail exposures. This result would be more consistent with the stated objective of creating incentives for banks to migrate to the more advanced approaches.

Capital Requirements Per $100 of Exposures	Current Accord	CP 3 Standardized	CP 3 A-IRB	A-IRB UL-Only
Credit Risk	$8.00	$6.00	$9.47	$8.12
Operational Risk	N/A	$0.42	$0.42	$0.42
Total Capital	$8.00	$6.42	$9.89	$8.54

The results demonstrate a capital requirement under the CP 3 A-IRB approach that is 24% and **54%** greater than the Current Accord and the CP 3 standardized approach, respectively. Even with the proposed changes to UL-only announced October 11 and assuming full coverage by loan loss reserves, capital requirements axe 33% greater than the CP 3 standardized approach. The stated intent of the A-IRB approach is to create incentives for banks to invest the resources and adopt more sophisticated risk

[8] This analysis assumes EL is fully covered by a reserve for loan losses, which is very unlikely in the case of unsecured retail revolving exposures. See response to Question No. 11, above.

[9] Taken from Visa® and MasterCard® quarterly industry reports.

management techniques. The New Accord, as drafted, fails to meet that objective with respect to credit card exposures. Indeed, it creates a major disincentive for a credit card bank to take action that could result in the application of the IRB approach. We believe this contradiction can be easily resolved with more appropriate AVC factors and FMI credit. <u>See</u> MBNA's AVC analysis and recommended factors in our general discussion of QREs at pp. 19-21, below.

23. 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. **(p. 45916)**

<u>Response:</u>

We support the $1 million exposure threshold (adjusted over time to allow for inflation) as a dividing line between small- and medium-sized enterprise ("SME") exposures that would be allowed to be treated on a pooled basis under the retail A-IRB framework. The underwriting process and performance characteristics of SMEs with exposures of $1 million or less are similar to other pooled basis products such as unsecured loans to individuals for non-business purposes. The recommended threshold continues to provide banking organizations with a cost-effective process for providing the product to the SME and to manage risk within this portfolio segment while continuing to provide a safe and sound loan portfolio.

Definition of Default and Loss (p. 45917)
Undrawn Lines (p. 45917)

24. 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. **(p. 45918)**

<u>Response:</u>

For retail exposures with uncertain future drawdowns, banks are required to incorporate an estimate of expected additional drawings prior to default in the calibration of the loss estimates. CP 3 broadly defines two methodologies banks can utilize: (a) the exposure at default ("EAD") methodology, which incorporates the open-to-buy (undrawn lines) into the EAD parameter or, (2) the LGD methodology, which measures the historical increase in drawings (over a 1-year period) and incorporates this in the LGD parameter.

We know through experience that there is not a linear relationship between the risk from additional draws and the open-to-buy. Relying on a constant percentage ignores the complexity in modeling any risk from additional draws and overstates the need for additional capital. Banks should be given broad discretion to use their own internally-developed models that fully consider the complexities in the actions banks employ, such as credit line decreases, to mitigate that risk.

Changing either the EAD or the LGD parameter generates a greater impact on the lower, rather than higher, PD segments since this is where most of the undrawn lines are concentrated. Over 90% of MBNA's available U.S. credit card lines are in accounts with PDs less than 2%. As a result, this approach unjustifiably penalizes the most creditworthy segments in a portfolio. We actively manage credit line exposures and utilize a variety of risk detection strategies to identify changes in the risk profile of our Customers. As noted in MBNA's comments to CP 3, we believe strongly that the risk related to undrawn lines is low, particularly where they are closely monitored and readily cancelable.

See MBNA's Letter to the Basel Committee on Banking Supervision (July 31, 2003)(enclosed at Appendix 2). See also response to Question No. 73, below, providing a detailed discussion of undrawn credit lines related to securitized loans.

25. 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 A-IRB treatment of such exposures. (p. 45918)

Response:

Like many other large credit card issuers, we actively manage credit line exposures. At MBNA, we employ a variety of risk mitigation techniques and strategies that prevent additional drawdowns for accounts that are at risk. We are able to minimize the increase in outstanding balance of borrowers through the following mechanisms:

- Risk detection strategies are employed that use predictive management technology to monitor account behavior and to identify borrowers with an increased risk profile that prepare these accounts for exposure mitigation action, including the reduction and closure of credit lines.

- High-risk accounts are identified by comparing current account activity with that of the account's historic behavioral norms. We look at whether there is unusual activity regarding credit line utilization, loan balances, the number of transactions, and the types of transactions of the individual Customer. By using this technology to monitor account behavior, we can identify Customers early in the process who may be having financial problems. This allows us to react quickly in order to mitigate the risk to the portfolio.

- In 2002, for MBNA's U.S. credit card portfolio, we reduced $3.9 billion in high-risk exposures through the use of these risk detection strategies. Two examples of our approach to line management are worth noting:

  - We employ authorization strategies that begin limiting borrowers from accessing their unutilized lines at 35-days past due. Using a proprietary internal behavior risk score, transaction level data combined with FICO score and other data and transaction type, we are able to evaluate risk related to Customer line usage.

  - We utilize automated reduction programs which, for example, target 5- to 35-day past due accounts, resulting in declined authorizations of $6.3 billion for 2003, year to date.

There is very little difference between an existing account expected to draw and a new account expected to book. Lenders will only permit future draws on uncommitted credit lines when appropriate capital is available. If at any time sufficient capital is not available, the lender would limit the ability for Customers to draw on open lines. Future draws on open credit lines are effectively contingent on adequate capital levels. Therefore, there is no need to set aside capital in anticipation of possible future exposure as prescribed under CP 3. With uncommitted credit lines, capital will always be adequate for exposure at default if capital is accumulated as actual draws are booked.

Because of the conditional nature of undrawn lines and because of the way in which those lines are managed, we believe the risk of undrawn lines is low and that the need for additional capital, if any, should be evaluated subject to a bank's internal models.

Future Margin Income (p. 45918)

26. ***For the QRE sub-category of retail exposures only, the Agencies are seeking comment on whether or not to allow banking organizations to offset a portion of the A-IRB capital requirement relating to EL by demonstrating that their anticipated FMI for this sub-category is likely to more than sufficiently cover EL over the next year.*** **(p. 45918)**

Response:

We agree with allowing banks that fall in the QRE sub-category to offset the EL component of the capital charge. In fact, we believe that the requirement to hold capital for EL is inconsistent with industry practice and should not be included in the final rule. We support the recent proposal to hold capital for unexpected losses only. However, we are very concerned that the Committee seems to be abandoning the concept of FMI and relying solely on loss reserves to cover expected losses. FMI should be retained as an offset to expected losses. The balance of our comments focus on the FMI construct included in the ANPR.

We believe that the ANPR requirement of the FMI exceeding the EL by at least two standard deviations to receive maximum credit is overly conservative and punitive to retail banks. Even if the FMI exceeds this very conservative threshold, the proposal allows only a seemingly arbitrary 75% capital reduction of the EL. We encourage the Agencies to consider – if the FMI test is met – allowing the credit to be 100% of the EL versus the proposed 75%.[10] Our experience, based on an analysis of our U.S. credit card securitization data over the past 60 months, shows that the average portfolio FMI (in this case defined as net interest income, less a servicing fee) is almost two times the mean ***gross*** charge-offs. This FMI calculation does not include the benefit from other non-interest related fees such as interchange income and is also exclusive of any recoveries from charged-off loans. The analysis also reveals a very low **16%** standard deviation to mean charge-offs thereby demonstrating the very high predictability of credit card losses.

27. 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? What are views on the proposed approach to inclusion of SMEs in the other retail category? **(p. 45918)**

Response:

Retail sub-categories

We agree that the three proposed retail sub-categories provide a reasonable balance between accomplishing differential treatment and avoiding excessive complexity. However, for the other retail sub-category, we believe that consideration should be given for allowing non-revolving unsecured retail loans where the FMI is more than sufficient to cover the EL to qualify for QRE. The unsecured non-revolving loans included in the other retail sub-category are unduly penalized when no EL credit is provided. This results from the failure of the A-IRB framework to consider that these loans are priced higher in order to recognize the EL inherent in the product. Non-revolving unsecured lending should be allowed the same FMI credit, so long as it can be demonstrated that future income more than covers the EL during the term of the loan.

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[10] Unfortunately, the FMI credit for the EL was reduced from 90% in QIS 3 to 75% in CP 3, without any empirical data to support this change.

Small Business Exposures

We believe that automatically classifying the SME loans as other retail is unnecessary. Where the loans are revolving, unsecured facilities guaranteed by individuals, the loans should be classified as QRE. These small business exposures are primarily underwritten and granted credit based on the credit standing and guaranty of the proprietor(s). The credit evaluation of the proprietor follows a very similar decision methodology as used for a self-employed individual in a retail credit card. The credit analyst reviews the proprietor's credit bureau, assessing FICO score, trade performance, existing retail debt, and personal income. Hence, many SMEs, have the same characteristics as revolving retail loans in the QRE sub-category and therefore should be classified as QRE loans. These loans should also qualify for the EL credit if they meet the FMI test.

Definition of Default

In general, we agree that either (a) a full or partial charge-off resulting from a significant decline in credit quality of exposure or (b) a notification that the obligor has sought or been placed in bankruptcy occurring prior to the mandatory FFIEC 120- or 180-day default trigger should be considered an event triggering default. However, we strongly disagree with the assumption that a distressed restructuring or workout involving forbearance and loan modification (collectively referred to herein as "restructured loans") should be included in the definition of retail default. Customers who are in restructured programs with modified terms have met all existing FFIEC guidelines of a renewed willingness and ability to repay the loan and have made at least three consecutive minimum payments typically resulting in a re-age of the account. These programs may be reflective of a temporary hardship (loss of job, medical emergency, or change in family circumstances like loss of a family member) or of a longer-term situation where a workout program, negotiated either directly with the institution or through a third-party debt counseling service, is established. Though these Customers may represent a higher risk, that higher risk is reflected in the risk segmentation and should not be included in the definition of default when calculating the EL.

We note that the proposed definition of default is inconsistent with the FFIEC's ***Account Management and Loss Allowance Guidance*** and the ***Uniform Retail Credit Classification and Account Management Policy,*** which specifically recognize that Customers should be provided the opportunity to rehabilitate themselves and meet their loan obligations. This new definition of default will have the effect of penalizing banks that assist Customers in resolving their financial difficulties. It will also have the effect of forcing banks to become more restrictive and less flexible in their willingness to assist Customers in restructuring their loans, thereby further damaging Customer credit histories and limiting their ability to borrow in the future.

We note that restructured accounts typically have a one-year EL of between 9% and 27% and this is reflective of the higher risk associated with these accounts. Although these restructured loans perform below portfolio averages, their performance does not support a need to include them as a "defaulted" account; rather, through the segmentation process, restructured accounts should be appropriately risk-weighted.

28. 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? **(p. 45918)**

Response:

See response to Question No. 24, above.

29. *The Agencies are seeking comment on the minimum time requirements for data history and experience with segmentation and risk management systems: Are these time requirements appropriate during the transition period? Describe any reasons for not being able to meet the time requirements.* **(p. 45918)**

<u>Response:</u>

We generally support a minimum of five years data history as outlined in the proposal and having a minimum of three years of experience with portfolio segmentation and risk management systems. With the additional cost required for capturing history and increased storage requirements for data elements, MBNA recommends a phasing in of the five-year historical requirement to be completed under the time frame discussed in response to Question No. 8, above.

We suggest that the Agencies clarify that the New Accord provide institutions with the necessary flexibility to rely on new advances in predictive modeling and other developments when calculating the PD, LGD or EAD, without needing to assemble five years of new data before changes in calculations can be implemented.

Retail Exposures: Formulas (p. 45918)
Residential Mortgages and Related Exposures (p. 45918)
Private Mortgage Insurance (p. 45919)

30. *The Agencies 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.* **(p. 45919)**

<u>N/A</u>

31. *More broadly, the Agencies are interested in information regarding the risks of each major type of residential mortgage exposure, including prime first mortgages, sub-prime mortgages, home equity term loans, and home equity lines of credit. The Agencies are aware of various views on the resulting capital requirements for several of these product areas, and wish to ensure that all appropriate evidence and views are considered in evaluating the A-IRB treatment of these important exposures.* **(p. 45919)**

<u>N/A</u>

32. *The risk-based capital requirements for credit risk of prime mortgages could well be less than one percent of their face value under this proposal. The Agencies are interested in evidence on the capital required by private market participants to hold mortgages outside of the federally insured institution and GSE environment. The Agencies also are interested in views on whether the reductions in mortgage capital requirements on mortgage loans contemplated here would unduly extend the*

federal safety net and risk contributing to a credit-induced bubble in housing prices. In addition, the Agencies are also interested in views on whether there has been any shortage of mortgage credit under general risk-based capital rules that would be alleviated by the proposed changes. **(p. 45919)**

<u>**N/A**</u>

Qualifying Revolving Exposures (p. 45919)

<u>**General Comments:**</u>

The New Accord provides a model that assumes an inverse relationship between the AVC and PD – the AVC falls as the PD rises and vice versa. This inverse AVC-PD relationship implies that the low-PD obligors would have greater stocks of wealth (e.g., liquid assets, stocks, and home equity) that provide a buffer against idiosyncratic shocks (job loss, divorce and health issues) relative to the high-PD obligors. It also assumes, however, that low-PD obligors would be more sensitive to systemic events (macroeconomic shocks).

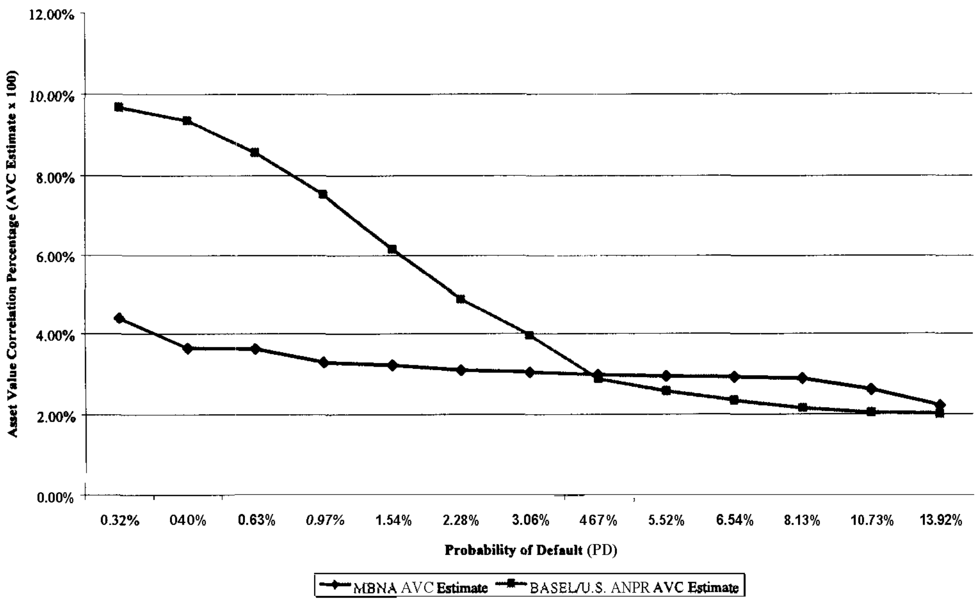
We can find little support for the notion that there is a steep inverse relationship between the low-PD Customers being more sensitive to systemic events in unsecured retail lending. We recommend that the Agencies lower the AVC factors related to low risk unsecured retail exposures. We believe that an AVC range of 2% to 5% for QREs is more appropriate than the current 2% to 11%. A corresponding change should also be applied to the other retail exposures calibration. However, we do not currently have a similar statistical analysis for other retail and would be open to additional research and validation using actual portfolio data prior to final implementation.

Our loss experience in our U.S. credit card portfolio is more representative of a less-steep/flatter AVC-PD relationship, with a much lower AVC factor for low risk exposures. At MBNA, Customers are not extended credit based solely on income, home value, job classification, or some other proxy for wealth. While these concepts are instrumental in establishing credit lines, MBNA Customers are granted credit based on solid, judgmental credit evaluation predicated not just on the Customer's ability to repay (wealth proxy), but also their stability and willingness to repay. In making lending decisions, MBNA credit analysts consider, among other things, an applicant's length of employment, homeownership, length of time at residence, debt-to-income ratio, and performance on existing loans with other creditors. Each Customer falls within established risk characteristics such as booked FICO and internal risk scores that are within range of the portfolio averages. These risk characteristics map to an expectation of future credit performance. No Customer is booked with a high expectation of default. The judgmental credit evaluation utilizes observable criteria to reach a decision that determines the Customer's ability to repay a given loan amount. Based on this practice, judgmental credit evaluation, not wealth proxies, ultimately determines credit risk. This business philosophy rejects the notion of the inverse relationship proposed in the New Accord. We are not able to comment directly on the relationship between PD and AVC at other unsecured retail lenders, but we suspect that their experiences would be similar to ours. In fact, the results of the Risk Management Association study dated February 2003 are largely consistent with MBNA's experience. <u>See</u> ***Retail Credit Economic Capital Estimation -- Best Practices,*** RMA Capital Working Group, Risk Management Association (Feb. 2003)(***"RMA Study").***

Through our own experience, we know that, as idiosyncratic and systemic shocks occur over Customers' credit life cycles, both low- and high-wealth Customers adjust their respective asset, consumption, and debt levels to avoid default. The periodic smoothing of assets, consumption, and debt among low- and high-wealth borrowers in combination with solid, judgmental credit underwriting should produce a flatter AVC curve relative to the PD.

The graph below was generated through an analysis of our own portfolio, producing an analytical estimate of the appropriate AVC.[11] The graph provides a visual depiction of how an implied AVC for MBNA's U.S. credit card portfolio demonstrates a relatively flat shape when applied to actual portfolio data, with significantly lower AVC factors for PDs less than *3%.* This suggests that MBNA's high-wealth/low PD Customers were not as sensitive to systemic risk as the proposed AVC-PD relationship implies.

MBNA Asset Value Correlation (AVC) and BASEL/U.S. ANPR AVC Estimates - October 2003



This graph clearly demonstrates that the A-IRB approach for unsecured retail lending creates excessive capital requirements, particularly for low-PD segments of the **portfolio.**[12] Similar to conclusions made by others in the industry, the inverse relationship between the AVC and PD is not well supported. According to the widely cited study by RMA on the New Accord, the median correlation value used by the industry for high-quality secured consumer loans (i.e. PD of 1%) is approximately **4%.** MBNA U.S. Card portfolio data produces a median correlation value of *3%.* The difference shows that each institution will have its own median correlation value. Accordingly, we recommend that each institution should be permitted to establish its own range of AVC factors. Rejecting that, the Agencies should at a minimum lower the range of AVC factors, as specified above.

As a point of reference, Appendix **4** compares the QRE risk weights by PD (assuming unexpected losses only) for AVC ranges of **2-11%** and **2-5%.** The CP *3* standardized risk weight of **75%** is included as a benchmark. As demonstrated by the graph, the **2-5%** AVC range produces a much more logical and balanced result, especially when compared to the standardized approach.

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[11] ***An*** explanation of the methodology is enclosed at Appendix 3, MBNA's America's Methodology in Producing the Appropriate Estimated Asset Value Correlation.

[12] In addition to default correlation approach, an EL-Sigma approach (see *RMA Study*) was also used to estimate AVCs by using the same portfolio data as the factor model employed. The EL-Sigma approach (using historical loss volatility as a measure of economic capital to reverse engineer the implied AVCs) validated the results of the factor model.

Future Margin Income Adjustment (p. 45920)

33. *The Agencies are interested in views on whether partial recognition of FMI should be permitted in cases where the amount of eligible FMI fails to meet the required minimum. The Agencies are also interested in views on the level of portfolio segmentation at which it would be appropriate to perform the FMI calculation. Would a requirement that FMI eligibility calculations be performed separately for each portfolio segment effectively allow FMI to offset EL capital requirements for QREs?* **(p. 45920)**

Response:

We agree that partial recognition of the FMI is appropriate in cases where the eligible FMI fails to meet the required minimum. However, the FMI test should be conducted, as described in CP 3, at the "sub-portfolio level consistent with the bank's segmentation of its retail activities generally ['at the national or country level (or below) should be the rule']" and not for each risk segment within a portfolio. See CP 3 at ¶ 202. Retail lenders, particularly unsecured retail lenders, price their products with the expectation that the portfolio FMI would be sufficient to cover the portfolio EL – that is, the FMI from the lower risk loans are expected to make up for the higher risk loans that eventually get written off. This provides diversification within the retail portfolio similar to how individual corporate loans would provide diversification to each other within a corporate loan portfolio. Unsecured retail lenders do not have collateral to count on so they look to the diversification and granularity within the portfolio to achieve the optimal risk-and-return balance. Although some pricing of the portfolio occurs at a segment level where risk is visible, such as risk-based repricing, the majority of pricing within a portfolio is based upon market and competitive factors. Pushing the FMI test down to the segment level would be best suited for an approach where individual accounts are reviewed and adjusted to meet earnings thresholds rather than for a pooled retail portfolio.

We are very concerned about the cumulative conservatism of Basel CP 3 which results in capital levels that no longer reflect minimum regulatory levels but rather target soundness levels that would normally be derived by internal capital allocation models. We note further that, similar to other large issuers, MBNA neither plans nor tracks actuals to this level of detail, as the costs of so doing outweigh any benefits. Any requirement to monitor FMI at this level would be a significant burden and would not correspond to the manner in which the business is actually managed, thus running counter to one of the principles of the New Accord. We know of no other institution that plans and tracks actuals to this level of detail.

Other Retail Exposures (p. 45920)

34. *The Agencies are seeking comment on the retail A-IRB capital formulas and the resulting capital requirements, including the specific issues mentioned. Are there particular retail product lines or retail activities for which the resulting A-IRB capital requirements would not be appropriate, either because of a misalignment with underlying risks or because of other potential consequences?* (p. 45921)

Response:

For loans that fall into the other retail sub-category, banks are required to hold capital for both the EL and the unexpected loss ("UL"). We believe this unduly penalizes non-revolving unsecured loans, (e.g., consumer installment loans) whose pricing is higher relative to secured loans (**e.g.**, auto loans). Secured lenders look to the value of the collateral for repayment in the event of default, and under the New Accord, benefit from a much more favorable LGD parameter because of this. Unsecured retail lenders, on the other hand in the absence of collateral, price their products with the expectation that the portfolio FMI would be sufficient to cover the EL. Unsecured non-revolving lenders, in effect, are penalized if they carry the higher LGD without any of the FMI benefit. We recommend that, similar to loans in the QRE sub-category, the non-revolving unsecured loans should receive **full** FMI credit, so long as the FMI can be demonstrated to be more than sufficient to cover the EL. This suggested approach is consistent with the recommendations of the RMA that, "EL should be subtracted from loss at the confidence interval with regard to all retail credit products, not just cards." See ***RMA Study*** at p. 52 (emphasis in original).

A-IRB: Other Considerations (p. 45921)
Loan Loss Reserves (p. 45921)

35. *The Agencies recognize the existence of various issues in regard to the proposed treatment of ALLL amounts in excess of the 1.25 percent limit and are interested in views on these subjects, as well as related issues concerning the incorporation of expected losses in the A-IRB framework and the treatment of the ALLL generally. Specifically, the Agencies invite comment on the domestic competitive impact of the potential difference in the treatment of reserves described above. (p.* **45921)**

Response:

We concur with the proposed treatment of the ALLL amounts in excess of the 1.25% limit.

36. *The Agencies seek views on this issue, including whether the proposed U.S. treatment has significant competitive implications. Feedback also is sought on whether there is an inconsistency in the treatment of general specific provisions (all of which may be used as an offset against the EL portion of the A-IRB capital requirement) in comparison to the treatment of the ALLL (for which only those amounts of general reserves exceeding the 1.25 percent limit may be used to offset the EL capital charge). (p.* **45921)**

N/A

Charge-Offs (p. 45921)
Purchased Receivables (p. 45922)
Capital Charge for Credit Risk (p. 45922)
Top-Down Method for Pools of Purchased Receivables (p. 45922)
Treatment of Undrawn Receivables Purchase Commitments (p. 45922)

37. *The Agencies seek comment on the proposed methods for calculating credit risk capital charges for purchased receivables. Are the proposals reasonable and practicable? (p.* **45923)**

Response:

We disagree with automatically setting the LGD to 100% if a bank is unable to decompose the EL for purchased receivables that qualify for the top-down approach and fall into either the QRE or the other retail sub-categories. We believe this would unnecessarily overstate the capital charge on the acquired portfolio, especially if the selling institution is a "general bank" that would not be expected to maintain the necessary historical files to assist the acquiring bank to segment the portfolio.

We recommend that the acquiring bank be allowed to use its own estimates of the risk parameters, even if there is not enough historic data to meet the minimum required, as long as it can demonstrate that the portfolio is similar to its current portfolio and the estimates are supportable. An acquiring bank should be able to produce a reasonably accurate forecast since it has to determine what to pay for a portfolio.

Where this is not possible, we recommend a transition period be established to allow the acquiring bank, should it choose this option, enough time to properly segment and align the acquired portfolio as well as build the database necessary to decompose the EL between the PD and the LGD. We believe a transition period of 36 months would be appropriate if the portfolio is acquired from a "general bank." During this transition period, the acquiring bank would be permitted to rely on the standardized approach for the acquired portfolio.

38. *For committed revolving purchase facilities, is the assumption of a fixed 75 percent conversion factor for undrawn lines reasonable? Do banking organizations have the ability (including relevant data) to develop their own estimate of EADs for such facilities? Should banking organizations be permitted to employ their own estimated EADs, subject to supervisory approval? (p. 45923)*

N/A

Capital Charge for Dilution Risk (p. 45923)

39. *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 wholesale A-IRB capital formula appropriate for computing capital charges for dilution risk? (p. 45923)*

N/A

40. *In particular, is it reasonable to attribute the same asset correlations to dilution risk as are used in quantifying the credit risks of wholesale 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? (p. 45923)*

N/A

Minimum Requirements (p. 45923)

41. *The Agencies seek comment on the appropriate eligibility requirements for using the top-down method. Are the proposed eligibility requirements, including the $1 million limit for any single obligor, reasonable and sufficient? (p. 45923)*

N/A

42. *The Agencies seek comment on the appropriate requirements for estimating expected dilution losses. Is the guidance set forth in the New Accord reasonable and sufficient? (p.* 45923)

N/A

Risk Mitigation (p. 45923)
Credit Risk Mitigation Techniques (p. 45923)
Adjusting LGD for the Effects of Collateral (p. 45924)
Repo-Style Transactions Subject to Master Netting Agreements (p. 45924)

43. *The Agencies seek comments on the methods set forth above for determining EAD, as well as on the proposed backtesting regime and possible alternatives banking organizations might find more consistent with their internal risk management processes for these transactions. The Agencies also request comment on whether banking organizations should be permitted to use the standard supervisory haircuts or own estimates haircuts methodologies that are proposed in the New Accord. (p.* 45925)

N/A

Guarantees and Credit Derivatives (p. 45925)

44. *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. (p.* 45925)

N/A

Double Default Effects (p. 45926)
Requirements for Recognized Guarantees and Credit Derivatives (p. 45926)
Additional Requirements for Recognized Credit Derivatives (p. 45926)

45. *The Agencies invite comment on this issue, as well as consideration of an alternative approach whereby the notional amount of a credit derivative that does not include restructuring as a credit event would be discounted. Comment is sought on the appropriate level of discount and whether the level of discount should vary on the basis of, for example, whether the underlying obligor has publicly outstanding rated debt or whether the underlying obligor is an entity whose obligations have a relatively high likelihood of restructuring relative to default (for example, a*

sovereign or PSE). Another alternative that commenters may wish to discuss is elimination of the restructuring requirement for credit derivatives with a maturity that is considerably longer – for example, two years – than that of the hedged obligation. (p. **45926)**

N/A

46. *Comment is sought on this matter, as well as on the possible alternative treatment of recognizing the hedge in these two cases for regulatory capital purposes but requiring that mark-to-market gains on the credit derivative that have been taken into income be deducted from Tier 1 capital.* (p. **45926)**

N/A

Mismatches in Credit Derivatives Between Reference and Underlying Obligations (p. **45926)**
Treatment of Maturity Mismatch (p. **45927)**

47. *The Agencies have concerns that the proposed formulation does not appropriately reflect distinctions between bullet and amortizing underlying obligations. Comment is sought on the best way of making such a distinction, as well as more generally on alternative methods for dealing with the reduced credit risk that results from a maturity mismatch.. (p.* **45927)**

N/A

Treatment of Counterparty Risk for Credit Derivative Contracts (p. **45927)**

48. *The Agencies are seeking industry views on the PFE add-ons proposed above and their applicability, Comment is also sought on whether different add-ons should apply for different remaining maturity buckets for credit derivatives and, if so, views on the appropriate percentage amounts for the add-ons in each bucket.* (p. **45927)**

N/A

Equity Exposures (p. **45927)**
Positions Covered (p. **45927)**

49. *The Agencies encourage comment on whether the definition of an equity exposure is sufficiently clear to allow banking organizations to make an appropriate determination as to the characterization of their assets. (p.* **45928)**

N/A

Materiality (p. 45928)

50. *Comment is sought on whether the materiality thresholds set forth above are appropriate. Exclusions from the A-IRB Equity Capital Charge. (p.* **45928)**

N/A

Zero and Low Risk Weight Investments (p. 45928)

51. *Comment is sought on whether other types of equity investments in PSEs should be exempted from the A-IRB capital charge on equity exposures, and if so, the appropriate criteria for determining which PSEs should be exempted. (p.* **45928)**

N/A

Legislated Program Equity Exposures (p. 45928)

52. *The Agencies seek comment on what conditions might be appropriate for this partial exclusion from the A-IRB equity capital charge. Such conditions could include limitations on the size and types of businesses in which the banking organization invests, geographical limitations, or limitations on the size of individual investments.* **(p. 45928)**

N/A

53. *The Agencies seek comment on whether any conditions relating to the exclusion of CDC/CEDE investments from the A-IRB equity capital charge would be appropriate, These conditions could serve to limit the exclusion to investments in such entities that meet specific public welfare goals or to limit the amount of such investments that would qualify for the exclusion from the A-IRB equity capital charge. The Agencies also seek comment on whether any other classes of legislated program equity exposures should be excluded from the A-IRB equity capital charge. (p.* **45929)**

N/A

Grandfathered Investments (p. 45929)
Description of Quantitative Principles (p. 45929)

54. *Comment is specifically sought on whether the measure of an equity exposure under AFS accounting continues to be appropriate or whether a different rule for the inclusion of revaluation gains should be proposed* **(p. 45930)**

N/A

C. Supervisory Assessment of A-IRB Framework **(p. 45930)**

Overview of Supervisory Framework (p. 45930)

Rating System Design (p. 45930)

Risk Ratings System Operations (p. 45931)

Corporate Governance and Oversight (p. 45931)

Use of Internal Ratings (p. 45931)

Risk Qualification (p. 45931)

Validation of Internal Estimates (p. 45931)

U.S. Supervisory Review (p. 45931)

55. The Agencies seek (commenton the extent to which an appropriate balance has been struck between flexibility and comparability for the A-IRB requirements. If this balance is not appropriate! what are the specific areas of imbalance, and what is the potential impact of the identified imbalance? Are there alternatives that would provide greater flexibility! while meeting the overall objective of producing accurate and consistent ratings? **(p. 45932)**

Response:

We believe that it will be difficult, if not impossible, to develop A-IRB requirements that are flexible and comparable. In the current environment there are no retail credit risk models that are comparable based on the unique approach that lenders take in underwriting and the differing approaches taken to calibrate and validate these models. We are concerned that the supervisorswill be ill equipped to understand these sophisticated models, much less identify issues that may create problems for individual institutions and/or the industry. Although the Current Accord is very simple, at least it is easily understood and interpreted by both banks and regulators.

56. The Agencies also seek comment on the supervisory standards contained in the draft guidance on internal ratings-based systems for corporate exposures. 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 drat? guidance for other types of credit? **(p. 45932)**

Response:

We have similar concerns to those voiced in our response to Question No. 55, above, as it relates to corporate exposures.

57. In addition, the Agencies seek comment on the extent to which these proposed requirements are consistent with the ongoing improvements banking organizations are making in credit-risk management processes. **(p. 45932)**

N/A

IV. Securitization (p. 45932)

General Comments:

Since 1986, MBNA has securitized over $135 billion of credit card and other consumer loans through more than 227 separate transactions. These transactions have been structured with loans originated in the United States, United Kingdom, and Canada. We have also played an integral role in the development of innovative securitization structures and have provided guidance to the Financial Accounting Standards Board and regulatory agencies on securitization matters. We believe the depth of our securitization experience uniquely positions us to recommend needed changes to the Committee's securitization proposal. We also support the efforts and comments provided by the American Securitization Forum.

We recognize the Committee's efforts in working to develop a more risk-sensitive treatment for securitizations (the "Securitization Proposal"). MBNA has been an active participant throughout the Basel II development process. We have participated in meetings with the Committee's securitization working group and have provided specific recommended changes. We are disappointed that, to this date, few, if any of our recommendations have been adopted. We note further that many of the comments provided by the securitization industry have also been ignored in large part.[13]

We nevertheless recognize and applaud the Committee's recent announcement concerning simplification changes to the securitization requirements, including changes to or elimination of the supervisory formula approach. Additionally, it is our understanding, based on discussions with industry participants, that the securitization results for QIS 3 did not achieve a desired level of accuracy. Because of these issues, we reiterate the concerns expressed previously on many occasions and implore the Agencies to consider fully our recommendations.

We have three principal concerns with the securitization proposal:

- Undrawn, uncommitted credit lines on accounts included in securitization structures;
- Early amortization capital requirements; and
- The overly conservative assumptions that create disproportionate capital charges for originators (compared to investors

These concerns are described in our responses below.

A. *General Framework* (p. 45932)
Operational Criteria (p. 45932)

58. ***The Agencies seek comment on the proposed operational requirements for securitizations. Are the proposed criteria for risk transference and clean-up calls consistent with existing market practices?*** **(p. 45932)**

Response:

The operational requirements for traditional securitizations are consistent with current practices at MBNA and to the best of our knowledge, other originators. Many of the operational requirements are based on current U.S. GAAP accounting (FAS 140). We do have some concerns that operational

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[13] The American Securitization Forum, Australian Securitisation Forum, European Securitisation Forum, Bond Market Association, International Association of Credit Portfolio Managers, International Swaps and Derivatives Association and Japanese Banking Association have participated either jointly or separately in the commenting process. MBNA participated in the drafting of and endorses the recommendations included in the securitization industry comment letter.

criteria will not evolve as current accounting practices change. The New Accord must reflect any possible future changes to accounting rules governing securitization.

The supervisory criteria related to clean-up calls are consistent with our understanding of current U.S. regulatory requirements.

Difference Between General A-IRB Approach and the A-IRB Approach for Securitization Exposures (p. 45932)

B. *Determining Capital Requirements* (p. 45932)
General Considerations (p. 45932)

General Comments:

The Agencies are proposing that capital requirements differentiate between originators and investors in securitizations. Asset-backed commercial paper conduits are considered to be originators. In general, we believe that originators should not be burdened with higher capital requirements when compared to investors in equivalent risk positions.

Further, we strongly recommend that any deduction, particularly related to Tier 1 capital, be net of tax effects. The capital account is only increased by the gain on sale, net of tax. It is important that this tax effect be considered when determining capital deductions.

Deductions of Gain-on-Sale or Other Accounting Elements That Result in Increases in Equity Capital (p. 45933)
Maximum Capital Requirement (p. 45933)

General Comments:

We agree completely with the Agencies' view that originators of securitization should not be required to hold more capital after securitization than would be required had the underlying assets not been securitized. We understand this is a reversal of current general risk-based capital rules. However, the A-IRB approach relies on K_{IRB}, which already considers the risk of the underlying assets to determine the maximum capital requirements. Under today's general rules, that risk is assumed at a constant 8%. Should the Agencies decide to change their position and remove the K_{IRB} cap on capital deductions, it would be another example of an overly conservative capital requirement within the New Accord.

59. *Comments are invited on the circumstances under which the retention of the treatment in the general risk-based capital rules for residual interests for banking organizations using the A-IRB approach to securitization would be appropriate.* (p. 45933)

Response:

It would not be appropriate to retain the general risk-based capital rules for residual interests for banking organizations using the A-IRB approach. Banking organizations should not be required to hold capital in excess of the capital requirements on the underlying pool of assets, plus capital deductions for credit enhancing I/O assets. Even with the cap, the A-IRB is too conservative, requiring too much systemic capital. In situations where originators retain interests and deduct capital, up to K_{IRB}, investors will also be required to hold capital against their securitization exposures. From a systemic perspective, regulatory capital requirements are increased for securitized assets.

60. ***Should the Agencies require originators to hold dollar-for-dollar capital against all retained securitization exposures, even if this treatment would result in an aggregate amount of capital required of the originator that exceeded the pool's A-IRB capital charge plus any applicable deductions? Please provide the underlying rationale.*** **(p. 45933)**

Response:

We do not believe that the Agencies should require originators to hold dollar-for-dollar capital against all retained securitization exposures. The securitization process does not create additional credit exposure to the originator. In fact, significant credit risk must be transferred to meet the requirements of securitization treatment. See CP 3 at ¶ 516. The requirement to hold dollar-for-dollar capital against all retained positions as proposed can actually penalize originators that hold large retained interests. In some cases, the decision to retain an interest in the securitization would be completely unrelated to risk retention. Funding costs could be lower for banking organizations that retain some of the subordinated classes versus selling to a third party. Under CP 3, the originator is forced to trade off a good economic decision against an arbitraty regulatory capital result. It would be better to allow lower (than dollar-for-dollar) capital requirements for retained interests that receive an explicit credit rating.

Additionally, revolving securitization structures typically contain a seller's interest (see example in Question No. 73, below). There is a pro-rata sharing of interest, fees, and charge offs between the investor and seller in these revolving structures. We ask that the Agencies clarify what we understand to be their position that the seller's interest does not represent a residual interest requiring "dollar for dollar" capital. This would be consistent with current U.S. practice.

Investors (p. 45933)
Originators (p. 45934)
Positions Below KIRB (p. 45934)
Positions Above KIRB (p. 45934)

61. ***The Agencies seek comment on the proposed treatment of securitization exposures held by originators. In particular, the Agencies seek comment on whether originating banking organizations should be permitted to calculate A-IRB capital charges for securitizations exposures below the KIRB threshold based on an external or inferred rating, when available.*** **(p. 45934)**

Response:

We believe that originating banks should be permitted to use external or inferred ratings for retained interests below K_{IRB} in order to determine capital requirements.

The ANPR requires originators to deduct from capital ***all*** retained positions between zero and K_{IRB}, even if the retained position is externally rated. This requirement is inconsistent with the requirements under the standardized approach, as specified in CP 3 at ¶ 530 ***(Originatorsto deduct below-investment or unrated securitisation exposures),*** which requires originating banks to deduct only those retained securitization exposures that are rated below investment grade. This inconsistency puts A-IRB banks at a competitive disadvantage to banks operating under the standardized approaches or the Current Accord.

The use of independent credit ratings is a fundamental component of Basel 11. The requirement to deduct exposures below K_{IRB} ignores the rating, if any, and applies a capital charge that is not consistent with the risk. We strongly recommend that retained, rated securitization exposures be subject to risk weights based on the rating of the exposure. With this change, unrated retained exposures not qualifying for an inferred rating would continue to be deducted up to predetermined limits (i.e., K, under the A-IRB approach). This would ensure greater consistency in risk assessment and not unfairly penalize originators. It should also be noted that Basel II already builds additional degrees of conservatism into its securitization capital requirements. For example, lower-rated securitization exposures require more capital than like-rated corporate exposures.

62. *The Agencies seek comment on whether deduction should be required for all non-rated positions above KIRB. What are the advantages and disadvantages of the SFA approach versus the deduction approach?* (p. 45934)

Response:

The New Accord requires banking organizations to hold capital for owned positions above K_{IRB}. Requiring non-rated positions above K_{IRB} to be deducted increases the capital cost of securitization. ***An*** easily applied SFA will allow banking organization to avoid deduction for non-rated positions above K_{IRB}.

Capital Calculation Approaches (p. 45934)
The Ratings-Based Approach (RBA) (p. 45934)

General Comments:

We support the ability to use external ratings to determine the capital requirements for securitization exposures. The ANPR refers to CP 3, 1525 for the external rating criteria. We recommend two changes to the criteria. First, principal repayments in securitization transactions do not always occur on a fixed schedule. Therefore, timely repayment of principal must be based on the legal final payment date for the securitization. Second, if more than one external rating is available, we recommend capital requirements based on a simple average of the ratings, not the lowest.

63. *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?* (p. 45936)

Response:

While there may be some advantages to multiple sets of risk weights for securitization exposures, we believe that two sets of risk weights would be sufficient, one for retail exposures and one for non-granular pools. Limiting the risk weights to these two sets would significantly simplify the treatment of securitization exposures, without sacrificing any risk sensitivity. The AAA and AA risk weightings for thick tranches backed by highly granular pools (i.e., the first column) should be used for the retail application. With retail securitizations, granularity is not an issue given to the large number of exposures. Also, AAA exposures are senior to all other exposures, therefore, seniority is not a question. This holds true for AA rated exposures to retail pools as well. It is unlikely that any AAA or AA rated retail securitizations would fail the thick tranche/granularity test. Accordingly, the distinction between "thick tranches" and the "base case" is unnecessary. In addition to simplifying the ratings-based approach ("RBA"), we ask that the Agencies lower the risk weights, particularly for senior tranches in retail securitizations. Based on the industry's loss analysis, lower risk weights are fully justified.

64. *For non-retail securitizations, will investors generally have sufficient information to calculate the effective number of underlying exposures (N)?* **(p. 45936)**

Response:

We do not have experience with non-retail securitizations, but sufficient information should be available to count the number of underlying exposures. It is important that investors have the ability to look through to the ultimate obligors in a securitization. For example, if the underlying assets in a securitization pool are composed of five senior tranches issued from retail securitizations, the retail securitization risk weights should apply.

65. *What are views on the thresholds, based on N and Q, for determining when the different risk weights apply in the RBA?* *(p.* **45936)**

N/A

66. *Are there concerns regarding the reliability of external ratings and their use in determining regulatory capital? How might the Agencies address any such potential concerns?* **(p. 45936)**

Response:

The consistency and reliability of external ratings are generally good and can serve as a reasonable method for determining regulatory capital. On some occasions rating agencies may disagree on the appropriate rating, these disagreements, however, are the rare exceptions and when they occur the difference is typically one rating's level.

67. *Unlike the A-IRB framework for wholesale exposures, there is no maturity adjustment within the proposed RBA. Is this reasonable in light of the criteria to assign external ratings?* *(p.* **45936)**

N/A

The Supervisory Formula Approach (SFA) (p. 45936)

68. *The Agencies seek comment on the proposed SFA. How might it be simplified without sacrificing significant risk sensitivity? How useful are the alternative simplified computation methodologies for N and LGD?* **(p. 45938)**

Response:

We support the position of the American Securitization Forum regarding the supervisory formula approach.

The Look-Through Approach for Eligible Liquidity Facilities (p. 45938)

69. *The Agencies seek comment on the proposed treatment of eligible liquidity facilities, including the qualifying criteria for such facilities. Does the proposed Look-Through Approach – to be available as a temporary measure – satisfactorily address concerns that, in some cases, it may be impractical for providers of liquidity facilities to apply either the "bottom-up" or "top-down" approach for calculating KIRB? It would be helpful to understand the degree to which any potential obstacles are likely to persist.* (p. **45938)**

Response:

We support the "look-through" approach for the risk weight assigned to the underlying tranche, when liquidity positions are not rated.

70. *Feedback also is sought on whether liquidity providers should be permitted to calculate A-IRB capital charges based on their internal risk ratings for such facilities in combination with the appropriate RBA risk weight. What are the advantages and disadvantages of such an approach, and how might the Agencies address concerns that the supervisory validation of such internal ratings would be difficult and burdensome? Under such an approach, would the lack of any maturity adjustment with the RBA be problematic for assigning reasonable risk weights to liquidity facilities backed by relatively short-term receivables, such as trade credit?* (p. **45938)**

Response:

We generally support the ability of liquidity providers to use internal-risk ratings, when mapped to the external ratings and to the risk weights under the A-IRB approach. In order to use internal risk-rating models, the liquidity provider must be able to demonstrate that its internal model will produce results generally consistent with rating agency models.

Other Considerations (p. 45938)
Capital Treatment Absent an A-IRB Approach – The Alternative RBA (p. 45938)

71. *Should be A-IRB capital treatment for securitization exposures that do not have a specific A-IRB treatment be the same for investors and originators? If so, which treatment should be applied – that used for investors (the RBA) or originators (the Alternative RBA)? The rationale for the response would be helpful.* (p. **45939)**

Response:

We believe that the A-IRB capital treatment must be the same for both investors and originators. Accordingly we submit that the RBA is the most appropriate approach for both investors and orginators. This is consistent with our views in general – ***originators should not be subject to overly conservative requirements when compared to investors.***

Structures with Early Amortization Provisions (p. 45939)
Determination of CCF's for Controlled Early Amortization Structures (p. 45939)
Determination of CCF's for Non-Controlled Early Amortization Structures (p. 45939)

72. ***The Agencies seek comment on the proposed treatment of securitization of revolving credit facilities containing early amortization mechanisms. Does the proposal satisfactorily address the potential risks such transactions pose to originators?*** **(p. 45940)**

Resuonse:

We support generally a proposal which recognizes that early amortization risks and their associated capital requirements will vary depending on both the asset type and the nature of the early amortization provision. We propose the following changes consistent with that view and with the view the New Accord requires additional simplification and clarity:

- The qualification conditions for "controlled" early amortization treatment should be revised to narrow the scope of the requirement to economic amortization events;
- The pro-rata conditions for controlled amortization should be eliminated and replaced with a clear overriding principle; and
- The initial reference level used to determine CCFs should be a clear and broadly applied trigger.

There are generally two types of amortization periods – the scheduled amortization or accumulation period (together "scheduled amortization") and early amortization, including economic pay-out events. The New Accord must clearly distinguish between these two very different events. Scheduled amortization occurs as specified within the underlying securitization documents. During scheduled amortization principal collections are no longer used to purchase newly originated loans, but retained by the trustee to repay the investor on the scheduled payment date. The economic pay-out event, however, occurs in those instances when "things go bad" and investors must be repaid early. The new capital requirement should only apply to these unscheduled events. The New Accord must make clear this important distinction.

We believe that the requirement that there be "a pro rata sharing of interest, principal, expenses, losses and recoveries based on the balances for receivables outstanding at the beginning of the month" is unnecessary and too restrictive. The necessary conditions for "controlled amortization" can simply require that:

a. The period for amortization must be sufficient for 90% of the total debt outstanding at the beginning of the amortization period or will be recognized as in default and

b. The amortization occurs at a pace no more rapid than a straight-line amortization.

Consistent with our overall view of the New Accord, we believe that the final version must articulate only guiding principles and not impose a set of highly prescriptive rules for early amortization. Accordingly, the pro-rata requirement is unnecessary and should be withdrawn from the final version.

The New Accord should opt for a simplification of the early amortization capital requirement. The initial reference level under the CCF methodology should be the lesser of 4% or the point at which the organization would be required to begin trapping excess spread. Because originators have different spread triggers for transactions from the same asset pools, this approach would allow for broad consistency across the industry, with four simple 1% quadrants. This standard starting reference point allows for ease in implementation making it operationally achievable for originators and verifiable for examiners. Moreover, it will not materially affect risk in that K_{IRB} actually captures the risk of the underlying assets and is included as a component of the CCF methodology.

73. Comments are invited on the interplay between the A-IRB capital charge for securitization structures containing early amortization features and that for undrawn lines that have not been securitized. Are there common elements that the Agencies should consider? Specific examples would be helpful. **(p. 45940)**

__Response:__

We believe there are common and overlapping elements between the capital charge for early amortization provisions and capital requirements for undrawn lines. The New Accord requires banks to hold regulatory capital for: (1) the **"owned"** (on balance sheet) retail loan exposures (both drawn balances and exposure to undrawn, uncommitted credit lines), and (2) retained securitization exposures, including a new early amortization capital requirement for loans securitized. The New Accord also requires banks to hold capital against undrawn lines related to securitized accounts, under the presumption that the institution is exposed to the credit risk of future draws. As discussed below, an analysis recently completed by MBNA demonstrates quite clearly, that in many cases, credit risk is actually transferred from the seller to the investor during revolving periods. Any final accord that includes a capital requirement for undrawn credit lines related to securitized loans must also permit banks to lower capital requirements when they can demonstrate risk mitigation due to the structure and performance of the securitization transactions.

	(a.) Beginning Balance	*(b.)* Customer Payments	(c.) Customer Activity	Ending Balance
Investor Interest	$900	($135)	$135	$900
Seller Interest	$100	($15)	$15	$100
Total Trust	$1,000	($150)	$150	$1,000

a. The seller transferred $1,000 of principal loans to the securitization vehicle (the "Trust"). Investors purchased an interest in the Trust by paying the seller par ($900) for an undivided interest in the Trust.

b. The seller retains the $100 remaining undivided interest in the Trust. During the period, credit card Customers repaid $150 of the $1,000 in loans originally transferred to the trust. The payments are allocated between the investor and seller based on their **"ownership"** interest in the

[14] Collection and billing of interest and fees are excluded from this example because the collection of interest and fees is used to meet other monthly obligations of the securitization (coupon, servicing fees and credit losses) and is not relevant to the discussion.

Trust at the beginning of the period. In this case, the investor is allocated 90% of the principal payments of $150 (900/1,000), or $135. The seller is allocated 10% (100/1,000) or $15.

c. Under the governing securitization documents, during the revolving period, the investor is required to purchase (at par) newly originated receivables from the seller, in order to maintain the investor interest at $900. The investor uses the allocated principal collections to purchase the new loan activity. In this example c, new loan activity equaled Customer payments; therefore, the beginning and ending balances were also equal. To clarify, if there were new loan activity of $150, then 90% of that activity would be allocated to the investor in order to maintain the investor's $900 interest – even if the $150 was related to high-risk accounts. There is no reason to require the seller to hold capital for the 90% of the new loan activity, which would be allocated to the investor.

d. If the new loan activity were less than Customer payments, the investor still purchases enough newly created receivables to maintain the investor interest of $900 and the seller interest would shrink. In example *d*, below, if new loan activity were **$140** (instead of $150), the balance in the total loan pool would shrink to $990. The investor would nevertheless purchase $135 of new loans to maintain an investor interest of $900. The seller interest, however, would shrink to $90.

	Beginning Balance	Customer Payments	Customer Activity (d.)	Ending Balance
Investor Interest	$900	($135)	$135	$900
Seller Interest	$100	($15)	$5	$90
Total Trust	$1,000	($150)	$140	$990

Again, there is no reason to require that the seller hold capital for 96.4% of the new loan activity that is allocated to the investor. This type of structure, which sells not only currently drawn balances, but also newly originated Customer receivables, should not be subject to the requirements of holding capital against undrawn credit lines.

As noted, our experience with securitization programs is consistent with example d, above, that shows the reduction of the seller's interest over a period of time. During the three-year period ending December 31, 2002, we added the U.S. MBNA Master Credit Card Trust II (the "Master Trust") new accounts that that had aggregate loan balances of $29.5 billion, measured as of the date each account was added. During the same period, aggregate loan balances with the Master Trust increased by $21.7 billion. Without the addition of balances from new accounts, both the aggregate loan balances in the Master Trust and the seller's interest would have decreased substantially. An analysis of each of MBNA's credit card master trusts produces similar results. A shrinking seller's interest reduces a seller's exposure to retail credit risk – it does not, as the New Accord suggests, increase that risk.

Should the Agencies conclude that capital must cover undrawn lines in securitized accounts, then originators should have the flexibility to reduce capital requirements when they can demonstrate that the originator's interest is expected to decline, as in example d above. This example demonstrates that a 1% decline in the total pool (from $1,000 to $990) results in a 10% decline in the seller's interest. Therefore investors are assuming some of the credit risk previously held by the originator. The New Accord, as currently drafted, presents a "one-way" risk distribution for undrawn lines. This approach ignores the indisputable fact that the seller's interest can just as easily decline as it can grow. As noted, our own experience reveals that a seller's interest is more likely to decline than it is to grow. Retaining the capital requirement as envisioned is yet another example of the excessive conservatism that will require far more regulatory capital than necessary.

We note also that if the requirement to hold capital against uncommitted credit lines from securitized loans arises from early amortization that risk is fully captured elsewhere in the new early amortization capital requirements contained in the New Accord. Any additional requirements are duplicative and unnecessary. In summary, each of the factors of (a) line management strategies, (b) the structure of revolving securitizaticws, and (c) the documented behavior of securitized loan pools, when combined with the New Accord's additional early amortization capital requirements demonstrates that, for uncommitted lines in revolving loan securitizations, there remains little risk to the seller.

74. *Are proposed differences in CCFs for controlled and non-controlled amortization mechanisms appropriate? Are there other factors that the Agencies should consider? (p.* **45940)**

Response:

We believe it is appropriate to maintain the differences between controlled and non-controlled amortization structures. We also reiterate our recommendation to adjust the requirements for controlled and non-controlled *early* amortization structures.

We also recommend a reduction to the CCFs for non-controlled early amortization **risk.** Approximately two years ago, MBNA completed an analysis of our U.K. credit card portfolio to help quantify the difference between controlled and non-controlled amortization events. The results of that analysis demonstrated that a controlled amortization structure would have 90% of loans repaid within a ten-month period. At the time, the underlying payment rate on the portfolio was approximately **15%,** indicating a non-controlled amortization period of between *six* and seven months. This would imply that a controlled early amortization would take about **1.5** times as long as a non-controlled early amortization. This analysis is based on observed pool characteristics during the covered time period. In the event of early amortization, payment rates on the underlying assets usually deteriorate, which would extend the time period for non-controlled amortization, narrowing the differential between controlled and non-controlled amortization. We recommend the following conservative CCFs for non-controlled early amortization structures: 0%, 2%, **4%,** 40%, and 80% or twice as large as the factors used for controlled early amortization.

Market-Disruption Eligible Liquidity Facilities (p. 45940)
Servicer Cash Advances (p. 45940)

75. *When providing servicer cash advances, are banking organizations obligated to advance funds up to a specified recoverable amount? If so, does the practice differ by asset type? Please provide a rationale for the response given. (p.* **45940)**

N/A

Credit Risk Mitigation (p. 45940)

V. AMA Framework for Operational Risk (p. 45940)

76. *The Agencies are proposing the AMA to address operational risk for regulatory capital purposes. The Agencies are interested, however, in possible alternatives. Are there alternative concepts or approaches that might be equally or more effective in addressing operational risk? If so, please provide some discussion on possible alternatives. (p.* **45941)**

Response:

We recognize that operational risk management is an emerging risk discipline and appreciate the progress that we see in the evolution towards a balanced, risk-sensitive framework. Our view is that the current state-of-the-art practices for operational risk measurement and modeling, however, have not progressed sufficiently to warrant a specific capital charge for operational risk. Should a capital charge ultimately be necessary, we believe that a transition period where no capital is specifically devoted to operational risk must be established to allow sufficient time for the banking industry's operational risk measurement discipline to develop such that a sound methodology can emerge. Because most large banks are currently well capitalized under the Current Accord, we see little risk in adopting this interim step. In the meantime, we suggest that core banks work with their supervisory authorities and other experts in the field to develop a methodology that accurately captures the operational risks that confront each institution.

In the alternative, should the Agencies conclude that there should be a specific capital charge for operational risk on the effective date of the New Accord, we would recommend that banks be permitted to use the alternative standardized approach (as described in CP 3, footnote 91). When and if the discipline reaches a demonstrated level of precision we believe necessary, banks could thereafter migrate to the AMA approach at their choosing.

We appreciate the flexibility offered in the AMA that will allow for the natural evolution of industry best practices. However, as is the case for a number of the credit risk capital requirements, there are certain aspects to the AMA that may undermine the development of industry best practices. We believe that many of the elements of the AMA are arbitrary or are based on scant industry data that may not be reflective of industry reality or experience.

We provide some specific examples of areas where further revision is necessary:

Expected Loss Offset **-** The sum of the EL and the UL will overstate capital requirements. A bank's EL is already being captured in its pricing, reserving, and budgeting practices. As with credit risk, capital committed to operational risk must be limited to UL and not include those events that are generally consider part the "cost of doing business" and planned and budgeted for on an annual basis.

Required Elements of Capital Calculation **-** There should be flexibility in the requirement that banks use internal data, external data, business environment and internal control factors, and scenario analysis in calculating capital levels. We would suggest these four components be recommended as data inputs and adjustment factors for calculation of operational risk capital, but not require that all four elements be used for all loss event types. The very nature of the defined loss event categories requires a different assessment and treatment of the risk that may include some or all of the four prescribed risk measurement elements.

A. *AMA Capital Calculation* (*p.* 45941)

77. ***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?*** **(p. 45941)**

<u>Response:</u>

The key elements are present for the broad structure of how banks manage operational risk. The risk measurement requirements, however, assume a level of accuracy that may take many years of broad industry data to achieve. Direct calculation of specific risk results to a 99.9% confidence level, with a verifiable degree of accuracy, will not be possible for most business lines, given the lack of available data, or will result in an extremely conservative capital charge, which would not make economic sense to the institution. We request clarification that the regulatory standards will reflect the practical necessity to generate results at lower confidence levels which can then be scaled to a higher target confidence level using an estimated scaling variable.

Based on the current state of data collection practices within the banking industry, it would be unwise to rely on this data in calculating operational risk capital. Although the operational risk measurement discipline is advancing at a rapid pace, we do not believe there is an agreed upon methodology within the industry that would lead to consistent capital levels for similarly situated banks (size, business lines, control framework, and overall risk profile). We recommend a fourth QIS be conducted for the purpose of gauging the progress made in operational loss data capture and the readiness of large banks to use this data for capital calculation.

We do not support the use of indirect losses in the definition of operational risk, based on the truly subjective nature of the process for calculating these losses. We believe that inclusion of indirect losses will artificially inflate any calculation of operational risk capital.

While capital is an important component of a bank's risk management toolkit and can provide meaningful protection against unexpected operating loss events, the cost of operational risk is typically a cost of doing business to be covered through operating earnings. Banks have made a significant investment in risk mitigation, such as establishing and maintaining risk-control systems, redundant data processing capability, internal and external audit oversight, and insurance protection. All of these form the first line of defense against the effect of operational loss events and are paid for through annual earnings. With all the focus on capital, we fear that these time-tested risk mitigation and control techniques will be potentially minimized thus resulting in poor economic capital allocation decisions.

Overview of the Supervisory Criteria (p. 45941)

__General Comments:__

We agree that the risk: management infrastructure is the critical element of any process to assess a bank's operational risk exposures. We believe greater supervisory emphasis should be placed on the qualitative criteria until the quantitative elements advance to the point where they can be relied upon to calculate regulatory capital.

78. *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?* (p. 45941)

__Response:__

We commend the Agencies on their efforts to define more clearly the regulatory expectations for operational risk management and measurement requirements/guidelines.

Although the guidance in the ANPR is an improvement from CP 3, there will remain little comparability in capital requirements from one bank to another based on the range of data collection practices, capital model assumptions, and other variables that significantly impact capital calculations.

79. *The Agencies are considering additional measures to facilitate consistency in both the supervisory assessment of AMA frameworks and the enforcement of AMA standards across institutions. Specifically, the Agencies are considering enhancements to existing interagency operational and managerial standards to directly address operational risk and to articulate supervisory expectations for AMA frameworks. The Agencies seek comment on the need for and effectiveness of these additional measures.* **(p. 45941)**

Response:

Requiring that banks use a particular approach when industry, market, and supervisory "best practices" are still very much in the development phase would be a mistake. At this stage in the development of operational risk measurement, supervisors need to encourage the creation of multiple innovative techniques, which we believe the AMA allows, with several exceptions where supervisors have prescribed parameters and thresholds. We understand the dilemma with which the supervisors are faced, balancing standardization of rules to foster comparability versus recognizing differences to allow for flexibility. The AMA provides flexibility, but lacks guidance for how examiners will determine whether a bank's processes can be certified for use under the AMA. This key issue requires additional direction and clarity. Our concern is that examiners may be inclined to create a "one size fits all" standard and enforce an impractical uniformity on the industry, that in the end will serve no one's best interest. A rules-based approach, which ignores the unique attributes of a particular business or institution, although easier to supervise and provide superficial comparison, may not in fact serve to either control or accurately measure risk. Examiners must look substantively at each institution's sophistication in managing risks and their ability to control and measure risk, before they apply consider applying rigid rules in the name of uniformity or efficiency of supervision.[15] In any event, we urge continued collaboration between the industry and the bank regulatory authorities in advancing risk assessment techniques for operational risk. At a minimum, the existing regulatory risk categories and defmitions must be modified to reflect what is proposed in the ANPR.

80. *The Agencies also seek comment on the supervisory standards. Do the standards cover the key elements of an operational risk framework?* **(p. 45941)**

Response:

We support the Committee's "Sound Practices for the Management and Supervision of Operational Risk" in lieu of the thirty-three proposed Supervisory Standards, set forth in the proposed draft supervisory guidance: published in the *Federal Register* in conjunction with the ANPR. The Committees "Sound Practices" principles clearly address the basic operational risk management framework requirements. We recommend that the more prescriptive Supervisory Standards (i.e., confidence levels, risk mitigation caps, etc.) be addressed as a part of the supervisory review and approval process for the analytical framework. We do not believe that the operational risk

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15 This general concern was expressed recently by Senior Fellow Robert Litan, of the Brooking Institution, in his analysis of the potential effects of the FFIEC's "Account Management and Loss Allowance Guidance. In this paper, Dr. Litan notes that

> "[I]t is well recognized among banks and knowledgeable observers that examiners tend to interpret guidelines as bright line rules. This is readily understanable. Bank supervision is difficult. Even those examiners who may spend their entire year within a bank cannot know with certainty all the risks to which banks are subject. It is a human reaction to complex situations to use rules rather than case-by-case judgment to guide behavior."

Litan, Robert E., ***Managing Credit Card Risks Without Unwanted Side-Effects,*** at p. 6 (the Brookings Institution, March 2003) measurement discipline has advanced to the point where the prescribed parameters and analysis techniques can be used with the necessary degree of confidence.

Corporate Governance (p. 45942)

81. ***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?*** **(p. 45942)**

Response:

As outlined in the ANPR, the roles of the institution's board of directors, of management, of the independent firm-wide operational risk management function, of the line of business oversight, and of audit (which would perform independent testing and verification) are clear. We believe that senior management has the ultimate responsibility for ensuring that appropriate risk management is in place. We believe that the board's role is primarily to provide effective oversight of management. It *is* the role of the board to ensure that management is in compliance with policy and that management takes the appropriate steps to monitor and control operational risk. In addition, the board should receive regular reports to monitor operational risk, including major events and activities. We also believe that it is the exclusive responsibility of management to oversee the development of the actual operational risk framework and to present that framework to the board for its review and approval. Management should be responsible for allocating resources and for ensuring that the company meets its operational risk objectives.

We question the need for a separate operational risk management function. We believe that the responsibility for operational risk management should reside with the business line and that the independent function should be limited to policy development, corporate-level reporting, and internal audit.

Operational Risk Management Elements (p. 45942)

B. *Elements of an AMA Framework* (p. 45942)

General Comments:

We have the following comments regarding the elements of the AMA framework:

- ***Business Environment & Internal Control Factors*** **-** We agree that assessment of the business environment and internal control factors are critical elements of assessing operational risk exposure. More emphasis should be placed on this element in the overall criteria based on a bank's internal control environment being the primary driver in its risk profile and operational risk exposures.

- Loss ***Thresholds*** **-** We request flexibility in setting thresholds for data capture to some materiality standard.

- ***Credit vs. Operational Losses*** – Verifiable segmentation of credit and operational losses in retail portfolios will prove to be very time consuming, judgmental, and may be of little value to banks.

82. The Agencies seek: comment on the use of external data and its optimal function in the operational risk framework. **(p. 45942)**

Response:

At some point in time: external loss data may be of value to banks for those loss event categories where there are few if any data points. Unfortunately, the quality and quantity of external data is sorely lacking. Until such time that the external sources gather loss data of sufficient breadth and depth, its use for capital calculation purposes is suspect. We remain skeptical of banks' ability to accurately scale external loss data to compensate for volume and control differences, which makes the use of this data for capital calculations dubious.

83. 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 are most binding against current insurance products? Other than insurance, are there additional risk mitigation products that should be considered for operational risk? **(p. 45943)**

Response:

We strongly believe the cap of 20% on insurance mitigation is without support. Banks must be permitted to demonstrate that insurance (and other forms of risk mitigation) will reduce both the operational risks and the corresponding capital that should be applied to those risks. We further believe that there must be an agreed upon methodology for how the mitigating effect of insurance will impact operational risk exposures.

VI. Disclosure (p. 45943)

General Comments:

Although we are generally supportive of increased transparency for market participants, we continue to have serious concerns regarding the scope of Pillar 3. As stated previously, we believe that the overall volume of disclosure mandated by the New Accord is unnecessarily burdensome, competitively harmful, subject to unwarranted market reaction, and of questionable usefulness to market participants.

Specifically with respect to the cost of providing disclosures versus benefits provided to investors and other users of the data, we believe that the cost of providing the additional disclosures will be significant, and it is highly questionable whether this cost will be justified by equal or greater benefits for market participants. Compliance with the disclosure requirements concerning areas such as operational risk will require the creation or acquisition of entirely new systems, infrastructure, and expertise within many organizations that do not produce this information today.

Moreover, the time considerations, given the increased volume of disclosure requirements imposed by the Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB") will also be unnecessarily burdensome. There must be coordination between the Agencies, the SEC and FASB in order to craft a disclosure regime which is both practicable for the institutions providing the information and meaningful for the users of that information. The SEC and FASB have subjected all public companies - not just regulated fmancial institutions - to demands for greater transparency. While these authorities are mandating ever-greater levels of disclosure on many topics, especially complex areas such as derivatives and securitizations, the time in which public companies have to produce and report disclosures has been drastically compressed. In early 2004, public companies will begin the phase-in of an accelerated SEC filing schedule for quarterly and annual financial reports. Upon completion of this phase-in, the SEC will have reduced by one-third the amount of time public companies are allotted to issue their annual report on Form 10-K (from 90 days to 60 days after year end) while the time for quarterly form 10-Q filing will be reduced from 45 to 35 days after quarter end. On top of greater disclosure and stricter deadlines, the need to provide management certification of disclosure controls and procedures and a report on the company's internal control over financial reporting under the Sarbanes-Oxley Act of 2002 has placed further demands on the resources which are necessary to provide this information.

In light of all of these: developments, it is in the best interests of reporting institutions and investors alike that a coordinated effort be undertaken involving all of the regulatory and standard-setting authorities. Moreover, given the FASB's stated goal of promoting convergence of international financial reporting standards with U.S. GAAP, we believe this effort must also include the International Accounting Standards Board. Promoting consistency among the disclosure frameworks of U.S. bank regulators, securities regulators and accounting standard-setters, and the international counterparts of each, is necessary to provide investors and other users with more comparable financial reporting by all entities incurring similar risks, whether U.S. or non-U.S., regulated or non-regulated, publicly traded or private.

We also believe that the requirement to provide the full set of this information on more than an annual basis is unwarranted. Annual disclosure for the most part is sufficient, with supplemental interim disclosures provided where there is a material change in the information provided previously. We note that Article 139 of the European Commission's Third Consultation Paper suggests a more flexible approach, leaving it to the "competent authorities" to determine whether financial institutions should publish required disclosures on more than an annual basis. See CAD 3, Article 139.

Rather than mandating these new disclosures at this time, we would support an approach suggested by the RMA and have supervisors, industry analysts, and bankers meet together between now and the final implementation of the New Accord for the purpose of developing a reasonable set of disclosures that market analysts could use to assess a bank's soundness.[16] The benefit of this approach is that, by working together, an appropriate amount of disclosures can be agreed upon to fully portray a given institution's risk profile without producing volumes of arcane and often irrelevant information that may produce little marginal benefit but which could have the adverse impact of creating competitive harm to reporting institutions. By formulating disclosure requirements in this way the industry, along with all stakeholders, would have the opportunity to harmonize all of the disclosure requirements with those mandated by the FASB and the SEC.

A. *Overview* (p. 45943)
B. *Disclosure Requirements* (p. 45944)

84. *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.* (p. 45945)

Response:

Please see our general comments herein and MBNA's Letter to the Basel Committee on Banking Supervision (July 31, 2003).

16 Risk Management Association's Letter to the Basel Committee on Banking Supervision at p. 29 (July 31, 2003).

85. *Comments are requested on whether the Agencies' description of the required formal disclosure policy is adequate, or whether additional guidance would be useful.* (p. 45945)

Response:

Should the Agencies reject our suggestion that the scope of the disclosures should be resolved through a consultative approach involving regulators, institutions, and industry analysts, we would suggest that the Agencies consider a more principles based approach with qualitative guidelines and recommended practices, rather than the highly prescriptive disclosure requirements set forth in Pillar 3. As noted by the Financial Services Roundtable, this would allow "the discipline of the market to produce continuous improvement in risk disclosure." This would produce information that the market actually desires, rather than seeking to impose today's ideas on future market participants by fiat.[17] In addition, from the market participant's perspective, the critical fact that the institution's primary regulator has reviewed through the supervisory process the safety and soundness of the institutions will have greater value and weight than an institution providing the voluminous and complex data. Accordingly, we would suggest each institution's primary regulator participate in the disclosure of critical bank information to market participants similar to what is done through the CRA process.

With respect to the Agencies description of the disclosure policy itself, the description must provide more specific guidance concerning the role of an institution's board of directors with respect to this function. It should address how specific such a policy "that addresses the institution's approach for determining the disclosures it will make" must be. Must the board approve every disclosure made by the institution? Would a committee duly appointed by a board of directors adequately fulfill this requirement? Why wouldn't the requirement under section 302 of Sarbanes-Oxley already meet the underlying purposes of this new requirement? Section 302 has gone beyond a description of the policy for disclosure and instead requires regular evaluation and reporting of the disclosure controls and procedures.

86. *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.* (p. 45945)

Response:

As discussed in our previous comments to the Committee, we strongly believe that many of the disclosure requirements mandated in Pillar 3 will cause substantial competitive harm. See MBNA's Letter to the Basel Committee on Banking Supervision (July 31, 2003).

The disclosure regime envisioned in Pillar 3 would disproportionately harm smaller institutions or those institutions with a limited range of products or businesses. Information provided by these institutions will reveal far more competitive information about the product, marketing investments and exposures than what would be disclosed by the larger institutions that have many businesses spanning multiple product offerings and business lines. We remain concerned that the New Accord strike the appropriate balance between the need for meaningful disclosure and the protection of competitive proprietary information.

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[17] Financial Services Roundtable's Letter to the Basel Committee on Banking Supervision at pp. 13 - 14 (July 31, 2003).

We further believe that by requiring regulated institutions to provide detailed quantitative and qualitative information about their capital structure, capital adequacy, and risk exposures and assessments (including the geographic and customer-type components of credit risk, credit risk mitigation, market risk, operational risk and interest rate risk), while their unregulated competitors are not, causes competitive harm. This information if provided will reveal proprietary information to the benefit of competitors. This unequal treatment will reveal sensitive information to our unregulated competitors who will reap the competitive advantages of this greater transparency without having to meet the same requirements and burdens the disclosures impose on regulated institutions. Ironically, it will be only the regulated institutions (which presumably operate in a safe and sound manner, at least in part because of the supervision process) that must meet these increased disclosure requirements, while unregulated competitors who are not supervised by the Agencies (and may not be as well controlled), will not. We further believe that this kind of information would be of limited value to the typical market participant, particularly when considering the competitive injury these forms of quantitative disclosures may cause. We therefore recommend that the Agencies consider limiting the disclosure requirements that harms institutions competitively and that may prove of little value to market participants.

87. *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.* **(p. 45945)**

Response:

We believe that the most efficient means for institutions to meet the disclosure requirements would be through each institution's public web site, in the same manner companies make available their SEC reports.

VII. Regulatory Analysis (p. 45945)

88. *The Agencies are interested in comments on the competitive impact that a change in the regulatory capital regime applied to large institutions would have relative to the competitive position of smaller institutions that remain subject to the general risk-based capital rules.* **(p. 45946)**

Response:

There is a view that the top ten largest banks will be able to reduce capital levels under Basel II. Given the significant concentration of assets and implied safety net provided by the FDIC for these large banks, there could be significant systemic risk from a significant reduction in capital held by the nation's largest banks. We are also concerned that the increased regulatory burden placed on this group of large banks will create competitive harm. Additionally, the rating agencies (S&P, Moody's etc.) have expressed concern about the possibility of a large reduction in bank capital ratios. Finally, there are a number of non-banking entities that are in the same business lines and will not be subject to the New Accord, which will contribute to an uneven playing field.

89. *Conversely, if the regulatory burden of the more prescriptive A-IRB approach applied to core institutions were so large as to offset the potential for a lower measured capital requirement for certain*

exposures, then the competitive position of large institutions, with respect to both their domestic and international competitors might be worsened. (*p.* **45946)**

<u>Resuonse:</u>

We agree with this potential concern as we have noted throughout these comments. We believe that the best way to avoid disparate treatment, which causes competitive harm, is to apply a framework that would apply to all regulated institutions. Although some risk sensitivity may be compromised, a simpler and more direct approach to risk-based capital calculations, universally applied, will redound to the benefit of all.

90. *The Agencies are also interested in comments that address the competitive position of regulated institutions in the United States with respect to financial services providers, both domestic and foreign, that are not subject to the same degree of regulatory oversight. . . . Quantitative information would be the most useful to the Agencies. However, commenters may also provide estimates of costs, benefits, or other effects, or any other information they believe would be useful to the Agencies in making the determinations. In addition, commenters are asked to identify or estimate start-up or non-recurring, costs separately from costs or effects they believe would be ongoing.* (*p.* **45946)**

<u>Resuonse:</u>

We anticipate incurring significant costs related to the implementation of Basel 11. Although we have no firm estimates at this time, we expect that the costs may be well in excess of tens of millions of dollars over the next several years to make necessary changes to our systems and processes, as well as significant on-going **costs** to comply with the Basel II-related requirements. At this point, it appears that we will not receive any capital relief and the benefits to be derived from the Basel driven changes remain unclear.

A. *Executive **Order 12866*** **(p. 45946)**

91. *If the OCC or the OTS determines that the rules implementing the New Accord comprise an "economically significant regulatory action," then the agency making that determination would be required to prepare and submit to the Office of Management and Budget's (OMB) Office of Information and Regulatory Affairs (OIRA) an economic analysis that includes [a description of the need for the rules and how the need will be met; a description of the anticipated benefits; an assessment of the anticipated costs for both the government and the affected businesses in administering and complying with the regulations and any adverse effects on the economy, productivity, employment and competitiveness; and an assessment of the costs and benefits of potentially effective and reasonable feasible alternatives to the planned regulation] . . . . The OCC and the OTC encourage commenters to provide information about:*

- *The direct and indirect costs, for core banks and those banks who intend to qualify as opt-in banks, of compliance with the approach described in this ANPR and the related supervisory guidance* (*p.* **45946);**

Response:

At this time, we have no firm estimates of what it will cost MBNA to comply with the New Accord as a core bank. We do know that we must commit substantial incremental resources in order to comply with and operate under the envisioned framework.

- *The costs, for general banks, of adopting the approach (p.* **45946);**

N/A

- *The effects on regulatory capital requirements for core, opt-in, and general banks (p.* **45946);**

Response:

Unless appropriate changes are made to truly reflect the risks related to unsecured retail lending, we expect a significant change in our current regulatory capital ratios. Regardless of how this New Accord is ultimately approved, however, we will take the steps necessary to maintain our historically strong capital position.

- *The effects an competitiveness, in both domestic and international markets for core, opt-in, and general banks. This would include the possible effects on the customers served by these U.S. institutions through changes in the mix of product offerings and prices (p.* **45946);**

N/A

- *The economic benefits of the approach for core, opt-in, or general banks, as measured by lower regulatory capital ratios, and a potentially more efficient allocation of capital. This might also include estimates of savings associated with regulatory capital arbitrage transactions that are currently undertaken in order to optimize return on capital under the current capital regime. That is, what estimates might exist to quantify the improvements in market efficiency from no longer pursuing regulatory capital arbitrage transactions? (p.* **45946);**

Response:

Without additional information, we remain skeptical about whether there will be any material economic benefits from the New Accord. The overall complexity will undoubtedly create capital distortions between products. The capital requirement for unsecured retail loans is one example of excessive regulatory requirements when compared to the economic risks of the product. These types of capital distortions will lead to the development and use of new regulatory capital arbitrage structures.

- *The features of the A-IRB approach that provide an incentive for a bank to seek to qualify to use it, that is, to become an opt-in bank.* **(p. 45946)**

Response:

Until the A-IRB approaches for QREs are modified to be more aligned with actual economic risk and result in lower capital requirements than the standardized approaches, there remains little incentive for an institution engaged primarily in unsecured retail lending to become an opt-in bank.

The OCC and the OTS also encourage comment on any alternatives to the regulatory approaches described in the ANPR that the Agencies should consider. (p. **45946)**

Response:

See response to Questions Nos. 2 and 3, above.

B. Regulatory Flexibility Act (p. **45946)**

92. Do the potential advantages of the A-IRB approach, as measured by the specific capital requirements on lower-risk loans, create a competitive inequality for small institutions, which are effectively precluded from adopting the A-IRB due to stringent qualification standards? (p. **45947)**

N/A

93. Conversely, would small institutions that remain on the general risk-based capital rules be at a competitive advantage from specific capital requirements on higher risk assets vis-a-vis advanced approach institutions? How might the Agencies estimate the effect on credit availability to small businesses or retail customers of general banks? (p. **45947)**

N/A

Appendix B

Letter from the U.S. House of Representatives
Committee on Financial Services
Comments to the **U.S.** Banking Regulators on the Advanced Notice of Proposed
Rulemaking on the Proposed Revisions of the Basel Capital Accord
(Nov. 3,2003)

MBNA
AMERICA

U.S. House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

November 3, 2003

The Honorable Alan Greenspan
Chairman
Federal Reserve Board
20th and Constitution, NW
Washington, DC 20551

The Honorable John D. Hawke, Jr.
Comptroller
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

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

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

Docket No. R-1154

Dear Sirs:

The House Committee on Financial Services submits these comments to the federal banking regulators on the advanced notice of proposed rulemaking (ANPR) relating to the proposed revisions of the Basel Capital Accord (Basel II). We want to commend you for your important work to address the much needed changes to the current Basel Capital Accord (Basel I). In particular, the Committee believes that the recent decision to recognize only unexpected losses as they relate to credit risk is an important step toward improving the Basel II proposal. This change will appropriately redirect the focus of regulatory capital, and we expect that the next version of the proposed U.S. rules will reflect this revision.

We emphasize the importance of considering the full range of implications associated with the new framework raised by ourselves and other commenters. We are concerned that major competitive and market structure issues raised in the proposal have been subsumed within highly technical text that may not have been understood fully by all commenters. We seek to foster a thoughtful and thorough examination of all the issues so that this country can move forward with a new regulatory capital framework that is compatible with existing good risk management practices, establishes appropriate incentives for prudent risk taking among banks, and does not impair either innovation or the competitiveness of the U.S. financial system.

The United States is the largest, most efficient credit market in the world. It is our responsibility as representatives of the American people to ensure that any changes to our markets resulting from a new regulatory capital standard be well understood and discussed throughout the political and regulatory establishments so that we can move forward together with our financial partners internationally. Moving forward hastily to meet arbitrary deadlines without adequate consideration of the domestic, as well as international issues, risks creating misunderstandings, and unintended consequences.

The Financial Services Committee has jurisdiction over the U.S. financial markets, as well as the structure, functioning and regulation of domestic financial institutions and international implications of the regulation. The Committee has actively followed the development of Basel II and has held two subcommittee hearings on these revisions. The Committee learned from these hearings that the proposal is extremely complex and that disagreement exists among regulators, the affected financial institutions, and academia regarding the likely impact of the Basel II proposal. The Committee is very concerned that the federal regulators are making important public policy decisions outside of the political process. The federal regulators must recognize that Congress plays a role in any regulatory process that could have a sweeping effect on the domestic and international banking system. It is our concern that the regulators are moving too quickly and without consideration of the impact of this agreement. When we met with drafters of Basel II we were routinely assured that the Accord will be improved to address our concerns, however, throughout the process we have seen few changes that satisfy us.

During the hearings, Members of the Committee expressed concern that the federal banking regulators were negotiating on behalf of the United States without express authority to bind the U.S. and its financial institutions to the agreement. Additionally, the Committee learned of concerns many banks in the United States have regarding the proposed regulatory capital treatment of operational risk and credit risk, as well as the impact the Basel II proposal would have on competition, the commercial real estate market, securitizations, and the international treatment of accounting.

If the changes to Basel I as whole, or individual parts, are designed to prevent banks from lending to specific higher risk borrowers, the framework effectively seeks to allocate credit only to the most credit-worthy borrowers. The message this conveys is that commercial banks should provide lending facilities only to the safest borrowers. It also suggests that time-honored secured lending practices which evolved over the years precisely to protect banks and enable them to lend to risky borrowers (and help fuel economic growth) may be disadvantaged relative to more liquid, more easily traded, and less secured forms of lending.

It is clear that at least certain parts of the banking industry are moving in this direction. However, if the regulatory capital framework seeks to accelerate this trend, it should do so clearly and a public policy debate should be invited on the wisdom of such a bias in the regulatory capital framework for the banking system as a whole. If no such sweeping changes are anticipated, then the Basel Committee and the U.S. federal banking regulators should seek to ensure that traditional lending activities are not disadvantaged throughout the framework.

Within the United States, the regulatory capital framework should strike a balance between ensuring that the U.S. financial system and the firms within it remain globally competitive without undermining the role of more traditional, domestically-focused firms. We have doubts that this balance has been struck within the current proposals.

This letter reflects the primary areas of concern that the Members of the Financial Services Committee have with the Basel II proposal. We look forward to your response to these comments.

The Basel Committee Negotiations

The Committee discovered in its February 27,2003 hearing that not all of the federal financial regulators were in agreement on how the current Basel Accord should be structured or what impact the current proposal will have on domestic financial institutions. In a second hearing held on June 19, 2003, the Committee received testimony from academics, financial institutions, and the federal financial regulators. At this hearing, greater agreement seemed to exist among the regulators, but not unanimity. The Members of the Committee believe that this discord weakened the U.S. negotiating position at the Bank for International Settlements (BIS) and resulted in an agreement that was less favorable to U.S. financial institutions.

H.R. 2043, the "United States Financial Policy Committee For Fair Capital Standards Act," was introduced by Financial Institutions and Consumer Credit Subcommittee Chairman Bachus, with Domestic and International Monetary Policy, Trade and Technology Subcommittee Ranking Member Maloney, to address these concerns and provide oversight for the Basel negotiations. This legislation establishes a committee among the financial regulators to ensure that there is a unified U.S. position in the negotiations at the BIS. The proposed committee would be chaired by the Secretary of the Treasury and would report its positions to Congress on a regular basis. H.R. 2043 was considered by the Subcommittee on Financial Institutions and Consumer Credit and approved unanimously by a vote of 42-0. The Full Committee has yet to consider this legislation.

It is critical that the Basel Committee strike the right balance between regulation that provides the necessary supervision for domestic and international banks while ensuring that these regulations do not stifle growth and innovation. Members of the Financial Services Committee agree that the current regulatory capital framework must be updated to reflect modern risk management practices and to eliminate regulatory arbitrage opportunities that the existing rules create. We are not convinced, however, that the current proposals would accomplish these goals. The proposals do not support modern risk management practices ,uniformly since they embrace banks' internal risk models in some areas while they would impose prescriptive, detailed regulatory calculation systems in others.

We are concerned that the bank capital charges created by Basel 11, if implemented, could be overly onerous and may discourage banks from engaging in activities which promote economic development. Crafting a framework that would create a two-tier banking system (diversified banks and non-diversified or specialized banks) through technical regulatory capital proposals without a full and public debate on the domestic implications is inappropriate.

We are concerned that in the process of negotiating a regulatory capital framework for globally active banks with diversified balance sheets, regulators may have not devoted sufficient attention to the likely impact that the new framework would have on the domestic financial system generally and on mono-line banks in particular. While the **ANPR** process initiated that dialogue within the United States, we are concerned that the process was begun too late to have a material impact on the structure and content of the international regulatory capital framework.

The Committee has been pleased to learn that the Basel Committee intends to initiate a fourth qualitative impact study (QIS 4). We are also pleased to learn that the U.S. banking regulators are studying the possible competitive impact of the proposal on the domestic banking system. Further, we understand that four major U.S. securities firms are similarly studying the possible impact of the new capital framework on their businesses. We strongly encourage delay in completion of the Basel II details until the results of these studies are collected and analyzed thoroughly. We also recommend that if the U.S. banking system could be adversely affected (either domestically or internationally), appropriate changes in the framework and its scope of application within the United States should be made.

Operational Risk

The Committee remains concerned that Pillar I treatment of operational risk could have unintended adverse consequences for many financial institutions, both domestically and internationally. Many institutions, particularly custodial banks, may be forced to change their business models in order to remain competitive if the Basel II proposal was implemented in its current form.

Basel II attempts to reduce regulatory arbitrage opportunities under the current framework. Regulators rightly seek to prevent firms from shifting assets within the balance sheet through instruments not specifically covered by Basel I. However, the Pillar I treatment of operational risk is not necessary in order to prevent this activity. In certain circumstances, Pillar I treatment could actually create new regulatory arbitrage opportunities if incentives exist for institutions to characterize certain losses (e.g., fraud) as operational rather than credit risk in order to obtain a more lenient regulatory capital treatment.

It is far from clear that requiring banks to track such losses as being both credit and operational in nature, but charging regulatory capital only against the credit risk loss is a good long run solution. This compromise suggests instead that industry best practices have not yet evolved sufficiently to articulate a clear regulatory capital standard. As noted above, this also suggests that regulators themselves have not clearly determined whether banks should be considered primarily as processing institutions (such that regulatory capital would be held principally to cover operational risks, which would include risks previously characterized as being credit in nature) or as credit intermediaries.

We believe that the proposed Pillar I treatment of operational risk is also misleading since it will not create an objective standard. The Advanced Measurement Approach (AMA) proposed within the Pillar I treatment would create significant scope for supervisory judgment and discretion. In addition, if Host supervisors must use Pillar 2 to top-up local regulatory capital in the event that the allocation from the Home country is perceived as being insufficient, then much of the certainty ostensibly created by Pillar 1 treatment is eliminated (Home/Host regulatory issues are discussed below). The Committee suggests that if the federal regulators and the financial industry have not yet settled on a best practice standard for measuring and assessing internal economic capital for operational risk, then the imposition of a Pillar I charge for this risk should be delayed until such an industry standard is developed. In the interim, regulators should not require a large number of financial firms to change their proven internal risk management practices.

When considering operational risk, a bank examiner must look at the nature of the risk, the quality of the controls that the bank has to address the potential risk, and the quantification of that risk. The regulator then must translate that risk assessment into a capital charge. This is a highly subjective exercise, given the amount of discretion available under the proposed AMA for operational risk. Pillar 11, or supervisory treatment, of operational risk would be consistent with the amount of discretion currently contemplated for the AMA within the proposal and, we believe, would be sufficient for U.S. institutions to address concerns regarding possible deficiencies in operational risk management that would arise during a bank exam. Pillar Two treatment would empower examiners to establish, on a case-by-case basis, the level of capital an institution would need to address these concerns. We do not believe that Pillar Two treatment would compromise comparability across borders upon implementation because so much discretion already exists within the current Pillar One proposal that we question whether it could be implemented in a comparable manner internationally.

The proposed Pillar I operational risk charge could also put U.S. banks at an undue competitive disadvantage at home and abroad. U.S. regulators cannot impose this charge on non-banks, which are major competitors in such areas as asset management, custodial services and payment processing. Internal economic capital requirements are markedly different from the proposed regulatory ones, which means that these large non-bank firms will operate at a significant advantage over banks in these key lines of business. We understand that some banks may abandon their charter and become non-banks, while others could be forced to sell these operations resulting in less effective customer service.

Finally, the Federal Reserve and the other financial regulators have been encouraging financial institutions to adopt critical infrastructure improvements to their systems. At the same time these institutions will be assessed an automatic regulatory capital charge for operational risk under Pillar 1. U.S. banks therefore would be charged twice for similar protection. In order to ensure that our financial system is protected, individual institutions must be encouraged to develop individual solutions to their risk needs. Imposing regulator-defined standard solutions for the broad range of intermediation activities and supporting operational processes is premature. Our concern is that a Pillar I capital charge could result in restrictions in risk mitigation efforts. We urge the U.S. federal regulators to rely on Pillar II for operational risk regulatory capital, while encouraging banks to enhance both their critical infrastructure protection systems and their operational risk management systems.

Commercial Real Estate

We believe that the Basel Committee has greatly improved the original Basel II proposal regarding the treatment of commercial real estate. We specifically note that the application of the wholesale risk weight function for corporate loans is a significant improvement. However, in order to ensure that banks are not forced out of the commercial real estate lending business as a result of an arbitrary capital charge, some additional changes are needed. Loans that have been designated as "high volatility commercial real estate" under the Basel II proposal will be subject to a modified wholesale risk weight function that will increase risk weights as much as 25% above what is charged for low asset correlation commercial real estate loans.

The ANPR designates acquisition, development and construction loans as high volatility commercial real estate loans, but exempts these loans from high volatility treatment if the borrower has substantial equity, or if the source of repayment is substantially certain. 'While these are important factors in assessing risk, sound lending policies often take into consideration additional elements when assessing the quality of a loan. Any attempt to draw a bright line between low asset correlation commercial real estate loans and highly volatile commercial real estate loans that do not have substantial equity or a repayment source would be highly speculative and could lead to a significant reduction in the amount of lending undertaken.

The Committee is concerned that the increased risk weight for these loans does not take into consideration the success experienced by many U.S. institutions engaged in acquisition, developmeint and construction lending. These types of loans provide much needed liquidity to the marketplace and foster economic growth. While the Committee agrees it is important to have a regulatory capital standard that avoids the kinds of real estate crises we have seen in the past, Members question whether the level of conservatism in the proposed treatment for these assets is appropriate.

The Committee recognizes that in the past losses related to construction loans presented a substantial risk, particularly overseas. The commercial real estate market has been implicated in a number of banking crises during the 1970s and 1980s in the U.S., Japan, and Europe. Since then, however, improved risk management standards and a tightening of lending pi-inciples have significantly reduced the risks that this type of lending can pose for the financial system. The Committee is concerned that the excessive conservatism regarding this asset class in the Basel II proposal fails to recognize improvements in risk management practices within the banking sector during the last decade. As a result, we are concerned that implementation of the proposals could stifle construction financing, which has been a major driver of economic growth in the U.S. We urge that the Basel II proposal be modified to provide unified treatment for all commercial real estate exposures including acquisition, development and construction loans.

Competitive Environment – Among Banks

U.S. financial regulators have announced their intention to apply the Basel II proposal only to the largest internationally active institutions. The presumption seems to be that only those firms will have the resources and interest in updating their internal risk management systems .in a manner compatible with the new framework. Other institutions would comply with Basel II on a voluntary basis.

The Committee is concerned that many banks on the cusp of qualifying for Basel II would be competitively disadvantaged by this proposal. These institutions will be forced to decide whether to make significant capital expenditures in order to develop the necessary systems and models to comply with the complex Basel II requirements. This is particularly true for operational risk, where best market practice has not yet emerged.

It is unclear how non-compliance with Basel II would affect small to mid-sized financial institutions. It is likely that the market and, in particular, rating agencies, will look more favorably upon Basel 11-compliant firms, resulting in these institutions gaining a competitive advantage against those that cannot comply. This could result in smaller institutions losing market share based, not on their lending practices, but solely on the effect of these regulations. Additionally this may generate increased concentration in the banking industry as institutions that are less competitive are bought by larger, Basel 11–compliant banks.

The Committee is concerned that excessive consolidation as a result of Basel II could reduce competition and access to financial institutions, as well as have a negative impact on customer service. The potential for artificial market manipulation through regulation is highly problematic. The new framework will reward banks with particular business lines (e.g., revolving credit and/or secured corporate lending) while penalizing banks with other business lines. The Committee is aware that increasingly the U.S. banking market is bifurcated between glo'bally active and domestically-focused banks. However, it is unclear how the existing market structure will be affected by a regulatory capital framework that seeks to penalize certain traditional forms of banking (e.g., commercial real estate lending; payments processing; unsecured corporate lending) while favoring other banking services (e.g., credit card lending; mortgage lending; secured corporate lending).

Competitive Environment – Between Banks and Securities Firms

Basel II will likely apply to U.S. securities firms with operations in Europe through the European Union's Capital Adequacy Directive. In addition, the Securities and Exchange Commission (SEC) recently issued proposed regulations to create an Investment Bank Holding Company Framework (IBHC) pursuant to its authority under the Gramm-Leach Bliley Act (GLBA). That proposal would require IBCHs to calculate internal economic capital in a manner consistent with the mechanisms contained in the Basel II framework. Because GLBA did not authorize the SEC to assess regulatory capital against IBHCs, the SEC cannot require such companies to hold regulatory capital in the amount generated by this calculation. In the United States, broker-dealers within the IBHC structure would remain subject to the SEC's net capital rule, which generally assesses increased regulatory capital charges against individual positions as liquidity in those positions decreases.

While regulatory capital charges impact all capital market participants, Basel II may disproportionately affect securities firms and investment banks. These firms mark-to-market their positions and immediately recognize changes in their risk profiles. The risk allocation mechanisms for credit and operational risks in this context may be substantially different than the one associated with accruals-based management measures upon which the Basel II framework. is based. The Committee further understands that the recently announced Basel Committee decision to calibrate the regulatory capital framework only to unexpected losses could alleviate some of the more egregious adverse effects on the firms that primarily market their traded credit portfolios to market.

In addition, we ,understand that the Basel II framework as currently drafted does not adequately address the difference between the trading and banking books of a financial firm. The Basel II framework also would impose significant new regulatory capital charges on fiims with a high proportion of processing activity, such as retail brokerage firms. As a consequence, Basel II regulatory capital requirements could misallocate capital and could artificially impair liquidity for securities and investment firms by requiring them to hold capital as if their assets were illiquid or unsecured.

Given these issues (availability of a new regulatory structure in the U.S.; marking to market; the operational risk charge), it is difficult to determine clearly which type of institution (e.g., banks, securities firms, processing banks) would be more disadvantaged than another. It is clear, however, that these kinds of significant changes in the regulatory capital structure for one kind of financial institution (banks) will have a competitive impact through the financial markets. It is not evident from the information available from either the Basel Committee or the U.S. federal banking regulators whether the competition between commercial depository institutions and investment banks has been considered.

We believe that a more thorough vetting of the possible competitive consequences is warranted in the United States, especially in light of the recent SEC proposals to create IBHCs with capital standards paralleling the Basel II standards. We encourage the federal banking regulators to delay any further decisions regarding Basel II until the data from ongoing impact studies have been evaluated fully.

Cost and Complexity

At this time it is difficult to quantify what the costs of the Basel II will be on financial intuitions in the U.S. Some institutions estimate that implementation will cost approximately $70 million to **$100** million to startup, even though they already use fairly sophisticated techniques for measuring economic capital on an internal basis. When these costs are multiplied by the thousands of banks within the global banking system, this may amount to billions of dollars in additional costs.

However, it is difficult to determine which costs could be attributed solely to the regulatory capital framework and which costs would be incurred by banks seeking to upgrade their internal .risk management systems. It is clear that some costs will be associated exclusively with regulatory compliance since the new regulatory capital framework would merely align (rather than converge) with firms' internal economic capital calculation processes. Some of these costs will be passed on to consumers and corporations, which would generate inefficiencies in the banking market.

The proposal is highly complex. As Comptroller Hawke stated in the February ***6*, 2003** hearing, "It is infinitely more complex than it needs to be. It is not complex simply because we are dealing with a complex subject. It is not only complex, it is virtually impenetrable." The Committee agrees that the regulatory capital framework needs updating and also recognizes that financial markets and intermediation activities have become more complex. However, we believe that the proposal is excessively complex and will create burdens for financial regulators around the world who will be charged with administering this Accord. While the resource challenges in this country will be significant, we worry that other countries with fewer resources will not have the capacity to implement the new framework, thus creating potential supervisory gaps and risks for the global financial system.

We believe it would be more advisable to adopt a simpler rule that supervisors can enforce equitably and effectively. This would eliminate potential competitive distortions, ensure that all banks will be able to understand their compliance requirements, and would facilitate in a meaningful implementation internationally. We encourage the federal banking regulators to seek wherever possible to streamline and simplify the new framework.

Securitization

The Committee welcomes the recent announcement that the regulatory capital treatment of securitization instruments will be simplified to reflect better existing risk management practices and data. Nonetheless, Committee Members are concerned that proposed treatment of securitized assets is overly harsh. Securitization vehicles, when used prudently, provide a useful mechanism for distributing otherwise illiquid credit risks throughout the capital markets.

The proposal to use regulatory parameters to require external ratings for **all** tranches of a securitization vehicle is problematic because some tranches will be rated internally. Failure to recognize internal ratings for these tranches suggests that banking supervisors trust unregulated rating agency processes and judgments more than the information and risk management tools available to the banks themselves, over which the regulators have direct oversight. This is inappropriate and is inconsistent with other parts of the proposed regulatory capital framework which would recognize banks' internal ratings subject to some standard regulatory assumptions.

We suggest that setting regulatory capital charges in relation to third party ratings for all securitization tranches is inappropriate since firms have sufficient data to assess the risks for a broad range of senior tranches, not covered by ratings agencies. We understand that data supporting internal ratings for all securitization tranches has been submitted to the Basel Committee and we urge serious reconsideration of the proposed approach in light of these comments and data.

The Basel proposal also calls for excessive capital when assessing regulatory capital for securitizations. This will lower incentives for banks to engage in activities that decrease their risk exposures and disseminate the risk of a particular transaction throughout the capital markets.

For example, the floor for the regulatory capital charge is too high for many securitization positions in light of their actual risk profile. Sub-investment grade positions in particular attract excessive capital under the proposal, given the actual credit risk they present. Implementation of the proposal could result in decreased access to credit for lower quality borrowers since banks would not be able to securitize these assets in an economically efficient manner. In addition, setting the regulatory capital floor in relation to individual transactions creates a cumulative regulatory capital charge that not only is excessive but could also be counterproductive. We understand that calculating the appropriate amount of regulatory capital for certain tranches of a securitization vehicle may be difficult since these tranches may be on the outside of the tail of the distribution. Nonetheless, it is neither fair nor appropriate to penalize other tranches of the vehicle which may have different risk characteristics and could affect credit access. We also do not understand why the Basel Committee may be willing to assess regulatory capital at the portfolio level for certain asset classes (e.g., revolving retail lending) but not others (e.g., securitization).

Finally, the Committee believes that Basel 11, as proposed, fails to recognize modern risk-management techniques regarding a wide range of accepted and important secured transactions (e.g., securities lending, repurchase transactions). By failing to recognize existing and accepted risk management activities through these instruments, the proposed regulatory capital charges would not reflect true balance sheet risk, resulting in decreased efficiency and increased cost for banks and their customers.

Future International Supervisory Interaction

In addition to the Basel negotiations, the Financial Services Committee is concerned with the nature and structure of implementation and enforcement of the new regulatory capital standard, whatever form it takes. Commonly referred to as the "Home/Host" issue, we are concerned because globally active banks increasingly need banking regulators to collaborate in new ways that may not have been contemplated by their authorizing statutes.

As the Home and Host to many leading international financial institutions, the United States plays a critical role in helping to create free, open, and competitive capital markets. We are keenly aware that the responsibilities of both the Home and Host regulator in the United States need to be balanced carefully so that the global competitiveness and the safety and soundness of the U.s. financial system is not compromised. We are also aware that the interlocking nature of global capital markets both enhances the ability of capital to find productive uses around the world and simultaneously increases the risk that weakness in one banking market can be transmitted internationally to another one.

We are concerned, therefore, to see suggestions that regulatory capital for operational risk may be determined only at the consolidated Home country level and then allocated down using an arbitrary and possibly crude mechanism that is not risk sensitive. This is especially problematic because it could undermine the credibility of establishing a risk-based capital framework. It is not convincing to suggest that Host regulators would have discretion to increase regulatory capital under Pillar II, since this would increase the perceived arbitrariness of the regulatory capital framework.

These concerns are compounded by the suggestion that this arbitrary mechanism would apply only in the operational risk area. Concern exists that such a system would increase banks' incentives to characterize risks and losses as operational risks instead of credit risks in order to benefit from a more lenient treatment. If the goal of the Basel Committee is to suggest that banks, as intermediators of information, are more appropriately to be considered processing stations rather than absorbers of risk, then it should be clear about its intent and a full public discussion should address this issue. If this is not the regulators' intent, then a more transparent and thoughtful approach is needed to resolve the conundrum associated with national regulation of global firms. We are also unclear and, thus, concerned with respect to how the new framework would be implemented and how regulatory capital will be assessed for a financial institution with multiple regulators.

We are aware that U.S. federal banking regulators continue to work with the Basel Committee on how to address this problem, particularly through the Basel Committee's Accord Implementation Group. In addition, we note that the SEC's proposal to create IBCHs complicates any regulatory coordination process, especially if the protocols for this process have been set among banking regulators only without including the SEC in their deliberations. We therefore encourage the federal banking regulators to be forthcoming about their views on how these issues can be addressed as quickly as possible.

Accounting Issues

The Committee notes with interest that a growing number of banks are advocating that the Basel Committee and the International Accounting Standards Board (IASB) work together so that the regulatory capital framework and the international accounting standards are not incompatible. We note that the internal ratings-based approach, under certain circumstances, may favor banks that fair value their banking book assets. Also, the accounting treatment of provisions may complicate implementation of the new framework, especially for those banks that mark assets to market and reflect changes in value through the profit-and-loss account rather than through the balance sheet.

Changing the regulatory capital framework to reflect market trends without having a full public discussion about the implications those changes hold for accounting and intermediation activities is inappropriate. Attempting to address the changes in a piecemeal fashion to meet an arbitrary deadline risks developing standards that are not well-crafted, not well-understood, and that could generate financial market volatility. We encourage federal banking regulators to be more forthcoming about their assessment of the interaction between the regulatory capital and accounting framework and their views on whether additional coordination between the two disciplines is needed in order to implement the new capital framework.

Conclusion

We applaud the U.S. federal regulators for all the hard work that has gone into the proposed Basel II Accord over the years. It is a substantial improvement over the current framework. However, the changes outlined above should be addressed in any additional modifications to the Basel II proposal following the commentary period.

The Members of the Committee understand that many of the concerns articulated in this letter are not unique to the United States and that our colleagues in Europe hold similar reservations, especially relating to the Basel II process and proposal. We strongly urge the Basel Committee to address fully the concerns raised by the political bodies in all of the affected countries.

The Committee views Basel II in a similar light as a trade agreement or treaties with foreign nations, which define the relationships between the U.S and foreign countries. Similarly, Basel II will define how U.S. and foreign financial institutions are supervised on a global level. Trade agreements and treaties are subject to Congressional review and approval as laid out in the Constitution. Consequently, we believe that Basel II should be reviewed by Congress prior to any final agreement that would affect U.S. and U.S.-based financial institutions in such a significant manner. Since it is expected that Basel II will be binding despite its informal status, we would like your views as to whether it could be viewed as establishing customary international law. If so, this could have significant implications regarding the rights and responsibilities of U.S. federal banking regulators when finalizing the new capital framework.

The Committee wants to ensure that no U.S. financial institutions are disadvantaged in the international marketplace and that the U.S. financial system remains internationally competitive and attractive. At the same time, we seek to ensure that no unintended consequences arise during implementation which could adversely affect our institutions, both large and small. Further, we want to ensure that an adequate public policy debate has occurred, both through the ANPR process and within the broader political process, to guarantee that all institutions understand and are prepared for the new framework.

Inaction on the items outlined above could force the Committee to take additional steps to ensure that the Congressional concerns are addressed. We appreciate your consideration of our coinments to the ANPR consistent with all applicable law and regulation, and we look; forward to your reply.

Yours truly,

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Chairman

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Ranking Member

Richard H. Baker
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