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Attn: Comments/Legal ESS

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Executive Summary

Merrill Lynch[1] welcomes the opportunity to comment on the Basel IA ANPR published in the Federal Register dated October 20, 2005 (Volume 70, Number 202). This publication represents a plausible attempt to address the competitive concerns raised by smaller banks by:

- Improving upon the risk-sensitivity of capital requirements under Basel I
- Developing a simple framework which is intermediate between Basel I and the more complex Basel II

As a matter of principle, Merrill Lynch supports the following key innovations implicit in the ANPR:

- Refining the risk sensitivity of the Basel I capital requirements
- Increasing the number of risk weights
- Incorporation of external ratings (when available), although this is less relevant than it might at first appear since smaller banks have less exposure to publicly rated entities
- Improved treatment of off-balance sheet commitments by introducing a new uniform risk weight regardless of maturity, thereby removing the artificial one-year maturity requirements for generating a non-zero risk-weight
- Linking the RWA for retail mortgages directly to LTV and borrower credit quality
- Improved collateral recognition

There are areas however, where the ANPR seems to be inadequate or incomplete, or simply does not go far enough:

- It is not clear from the language whether it is the regulatory intent that all US banks (not on Basel II) are mandated to move from Basel I to Basel IA
- Although the ANPR suggests additional risk weights, the criteria determining these weights are left open to public comment. This makes it difficult to assess the proposal in a meaningful way

[1] Merrill Lynch comprises a number of legal entities regulated by various supervisors including two banks supervised by the FDIC, both of which together comprise in excess of $75 billion in assets. ML&Co. is also a C.S.E. with the S.E.C.

- It is not clear whether risk weights for non-rated wholesale exposures would remain unchanged, or whether they would inherit the worst risk weight of 350% associated with borrowers rated B and lower
- While it is encouraging that the Agencies are willing to consider relief for publicly rated securities posted as collateral, the ANPR does not go far enough:

    i. There is ample evidence of significantly improved recoveries for secured corporate lending for certain types of collateral relative to unsecured lending[2]
    ii. Recovery experience for certain classes of asset-based-financing can exhibit very high recovery rates, even though the collateral is not publicly rated (see §B below for more details)

- FICO scoring is the obvious objective measure of the borrower criteria in the U.S. retail sector, and as such plays the same role as ratings for public companies. Yet the ANPR seems to stop short of allowing the risk weights for retail products to be linked directly to FICO scoring
- Smaller banks tend to concentrate on small business lending, and here the ANPR offers little in the way of concrete proposals, but instead seeks comments. The one proposal offered was a 75% risk weight for certain exposures under $1 million, which is unlikely to have a material capital impact across the industry

Merrill Lynch has some specific recommendations to offer which we believe would materially improve the proposed Basel IA framework and make it more risk sensitive (less capital requirements for less risky exposures and vice versa):

1. Allow non-Basel II banks the option to remain on Basel I

    a. The cost/benefit analysis may not justify the migration, particularly for smaller banks
    b. There may be no material changes in overall capital levels for many banks

2. Confirm that the current Basel I risk weights will remain in place for those wholesale exposures which are not externally rated
3. Link the retail risk weights directly to FICO/LTV segments (see §A below), so that low FICO exposures would attract proportionally more capital and vice versa
4. Allow a reduction in risk weights for certain fully collateralized exposures, where the collateral can be readily marked to market and is perfectible, even though it is not externally rated (see §B below)
5. For collateralized lending to middle-market companies, link the risk weight directly to objective benchmarks such as a D&B rating (see §C below)

Finally, Merrill Lynch seeks clarity on whether the floors proposed for Basel II (95% in 2009, 90% in 2010 and 85% in 2011) are to be calculated relative to Basel I or Basel IA. It appears to make no sense that these floors would be set relative to Basel IA, as that would force Basel II mandated banks to effectively run 3 regimes in parallel (Basel I, Basel IA and Basel II).

[2] For example, S&P has a detailed database of several thousand recoveries in the US going back to the 1970s and is available as part of the LossStats vendor model

The remainder of this comment letter addresses the specifics of recommendations 3, 4 and 5 above.

Detailed comments

§A. Retail Mortgages/Helocs

In the process of calibrating the Basel II risk weight function, the Regulators had to develop a mapping from FICO/LTV to PD/LGD for mortgages. One byproduct was to assign risk weights to various FICO/LTV combinations. The results of this mapping, shown in Table 1, can be found in the paper "The Asset Correlation Parameter in Basel II for Mortgages on Single-Family Residences": Paul Calem and James Follain, Board of Governors of the Federal Reserve, November 2003.

Most banks (large and small) record FICO and LTV at origination for their mortgage lending activities. Hence it would be quite easy for such banks to directly use the risk weights in Table 1.

Regulators might feel it necessary to adapt Table 1 in the following ways:

- Bucket the FICO/LTV segments together to achieve a coarser set of risk weights
- Develop a similar table for ARMs/hybrids
- Develop a similar table for HELOCs/Second Mortgages using FICO and combined LTV

The underlying data required to develop the adjusted tables for ARMs is readily available to Regulators. Moreover, existing data sets for first mortgages can be readily adapted to estimate risk weights for second liens as in the following steps:

- For each FICO/CLTV segment, use the PD implied by the appropriate first mortgage table
- Treat the first and second liens as a single mortgage and use the appropriate first mortgage table to estimate the recovery rate on the total property
- Estimate the LGD on the second lien by using the industry average level of subordination to estimate the recovery rate on the second lien as the residual amount left after paying off the first lien
- Plug the PD/LGD parameters so obtained into the Basel II formula to estimate the appropriate risk weight

LTV / FICO Score	Annualized 10-year Default Rate (PD) (percent) (1)	Loss Generated by Default (Recession LGD) (percent) (2)	Risk Weight (percent) (3)	Marginal Tier 1 Capital Requirement (Basis points) (4)
70 / 620	0.27	16	9	34
70 / 660	0.16	16	6	23
70 / 700	0.10	16	4	16
70 / 740	0.07	16	3	12
80 / 620	0.51	25	21	85
80 / 660	0.31	25	15	59
80 / 700	0.20	25	11	42
80 / 740	0.15	25	8	34
90 / 620	1.00	33	46	182
90 / 660	0.62	33	33	131
90 / 700	0.42	34	25	100
90 / 740	0.30	34	19	77
95 / 620	1.38	36	62	248
95 / 660	0.87	37	46	183
95 / 700	0.58	37	35	138
95 / 740	0.43	37	28	111
Jumbo Prime Pool	0.27	25	13	53
Alt-A Pool	0.28	35	19	77
Seasoned & Diversified Portfolio of Prime Loans	0.19	25	10	40

Table 1

The industry average level of subordination can be found in the Letter from MICA to the FRB commenting on Basel II, November 2003. This information is contained in Table 2 below, along with MICA's estimate of second lien LGD

	Gross LGD estimates						
CLTV	100	97	95	90	85	80	75
First Lien Size	78.70%	78.70%	78.00%	75.20%	67.40%	61.70%	56.60%
Second Lien Size	20.70%	18.30%	16.40%	14.10%	16.40%	17.30%	16.80%
Second Lien LGD	95.20%	92.90%	89.80%	75.30%	46.70%	28.60%	7.70%

Table 2

§B. Reduction in risk weights due to improved collateral recognition

While the ANPR holds out the possibility of capital relief for publicly rated securities posted as collateral, this proposal does not go far enough. There is ample evidence of far higher recoveries for secured lending vs. unsecured lending, even when the collateral posted is not rated. Both Moody's and S&P have databases that can support this and quantify the difference in appropriate risk weights for certain classes of collateral.

Table 3

Seniority	Mean	Std. Dev.
Senior Secured	54.26	25.82
Senior Unsecured	38.71	27.80
Senior Subordinated	28.51	23.41
Subordinated	34.65	22.23
Junior Subordinated	14.39	8.99

: Recovery by Seniority (Moody's, 1970-2003)

For example, the above Table 3 appears in the paper by Til Schuermann of the Federal Reserve Bank of New York called "what do we know about Loss Given Default". It shows that the LGD for senior secured lending is on average 25% less than that of senior unsecured lending. A more refined analysis of the Rating Agency databases would easily pin down the precise difference by major collateral type. Such an analysis would clearly show an enhanced expectation of recoveries for secured vs. unsecured lending for certain collateral types such as Inventories & Receivables which are (invariably) non-rated securities. One would also see that secured vs. unsecured recovery rates would not differ much for collateral such as Intellectual Property.

To generate the risk weight appropriate to the enhanced recovery rate, one could plug the associated LGD % into the Basel II formula. Of course one may chose to add back a charge for operational risk to maintain comparability with Basel II. A crude estimate shows an average risk weight reduction of 25% for certain classes of collateral outside publicly rated securities.

In the case of certain classes of asset-based financing, the lack of recognition of non-rated collateral can lead to even greater economic distortions. The prototype example is where a lower rated counterparty (typically a financial institution) borrows say $A, but posts more than $A as collateral. The collateral posted is typically a pool(s) of retail receivables which is haircut from the current market value. This leads to the following situation:

- Under the ANPR, such counterparties would likely receive a 200% risk weight. Given that the collateral is not publicly rated, the RWA for this transaction is then $2A.
- On the other hand, the lender typically has ring-fenced the collateral with what amounts to a first lien. The securitization market can then be used to benchmark the rating which would be applied by a Rating Agency. The resulting facility rating is typically of the order of 3 to 4 notches higher

than the public counterparty rating. This implies a reduction in economic LGD of the order of 75%.

- The economic LGD reduction would yield the same reduction in Basel II RWA for this collateral. Assuming a maturity of 2.5 years and an initial counterparty rating in the BB range, this would imply RWA of approximately $A.

One concludes from this analysis that the risk-weight could easily be off by a factor of 2 for such Asset-Based Financing under Basel IA.

Given these considerations, Merrill Lynch would propose the following:

Expand the collateral eligibility under Basel 1A to allow recognition of collateral, which though not publicly rated, nevertheless:

a. Is legally perfectible
b. Can be readily marked to market
c. Covers more than 100% of the exposure

For such collateral, allow a 50% reduction in the risk weight assigned to the facility, assuming that the risk weight assigned to the identical but unsecured facility to the same counterparty would be 100% or greater.

§C. Risk-weight reduction due to superior coverage ratios for middle-market obligors

Merrill Lynch welcomes the ANPR proposal for reduced risk-weights associated to exposures <$1 million. To develop a more risk sensitive weight for exposures >$1 million on a consolidated basis, it is clear that an objective measure of credit quality is required. There are essentially two options here:

i) Use ratios from audited financial information to derive the appropriate risk weight
ii) Link the risk weight directly to a rating from an objective party

Implementing option i) would require a statistical analysis on an appropriate middle-market database to estimate default rates associated with ranges of key financial ratios. Given the highly non-linear interactions between credit quality and such ratios as interest coverage, balance sheet leverage etc., this would be tantamount to building a scoring model, where the risk weights would be most appropriately set by combinations of key ratios in a manner similar to that of Moodys' RiskCalc. This solution is probably not the appropriate one for regulatory supervision, as it would require complex systems to track the obligor financials in real time.

Option ii) provides an easier solution. Dun and Bradstreet already assess a credit score in this market segment. The score is on a scale of 1 to 5, with 1 representing low default risk and 5 representing high risk. According to D&B, the score captures the likelihood that a company will not experience financial distress over the next 12 months. Moreover, the failure rate associated with each score is known (e.g., "4" has a failure rate of 8.3% which equates to a credit in the B to B- range). D&B has several other ratings which could serve equally well.

Given that such objective scores exist, the next task would be to assess a Basel II equivalent risk weight by plugging in the indicative PD associated to the score into the AIRB risk weight to develop a table of

risk weights for the D&B scores. This would be quite simple to implement (provided one had the score to begin with).

In conclusion, Merrill Lynch welcomes the Basel 1A ANPR and looks forward to the forthcoming publication of the Basel 1A and Basel II NPRs.

Sincerely,

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