To:	Basel II NPR Public File
From:	Mark Van Der Weide and Allison Breault
Date:	August 10, 2006
Re:	Board Staff Meeting with the Institute of International Bankers and the Institute of International Finance

On August 1, 2006, Federal Reserve staff met with representatives of the Institute of International Bankers and Institute of International Finance (collectively, "Associations") to further discuss their concerns about the interagency notice of proposed rulemaking to implement the Basel II capital accord ("Basel II NPR").

The Associations expressed concern that U.S. subsidiary banks and bank holding companies of foreign banking organizations would be subject to the U.S. Basel II capital rule on a mandatory basis, regardless of the applicability of Federal Reserve SR letter 01-01, if the foreign banking organization's top-tier U.S. bank holding company had $250 billion or more in total assets.[1] They also questioned how the Federal Reserve will make capital equivalency determinations in the context of financial holding company elections by foreign banking organizations, given the temporal and substantive differences between U.S. implementation of Basel II and implementation of Basel II in other jurisdictions. In addition, the Associations requested that the forthcoming Basel IA NPR permit foreign banking organizations to opt-out and remain subject to the current capital regulations. The Associations also reiterated their concern that the Basel II NPR is more conservative than, and otherwise different in many ways from, the Basel Committee on Banking Supervision's revised framework published in July 2004. The Associations provided the attached list of differences between the draft Basel II NPR and the capital requirements directive of the European Union.

Attachment

The list of attendees included:

Lawrence Uhlick	IIB
Ken Bachman	Cleary Gottlieb Steen & Hamilton LLP
Michael Kadish	Deutsche Bank
Tom Rosenkoetter	HSBC
Caitriona O'Kelly	IIF
Russell Gibson	Royal Bank of Scotland
Linda Lord	UBS
George Pombar	Israel Discount Bank
Ashton Abbot	IIB
Adam Schenk	IIB

[1] SR 01-01, "Application of the Board's Capital Adequacy Guidelines to Bank Holding Companies Owned by Foreign Banking Organizations," January 5, 2001.

Federal Reserve Board:
Roger Cole
Steve Roberts
Norah Barger
Robin Lumsdaine
Anna Lee Hewko
Walt Miles
Lisa DeFerrari
Kathleen O'Day
Ann Misback
Mark Van Der Weide
Allison Breault

Check List of Inconsistencies and Differences between Advanced Methodologies Under the NPR and CRD

1. **<u>Asset Securitization Maturity Mismatch in Synthetic Securitizations</u>**
   In case the tenor of the credit derivative is shorter than the longest tenor out of the securitized asset pool, the tenor of the credit derivative must be taken most conservatively. Capital build-up is required starting 5 years before the maturity date of the program and gradually increases. We believe that expiry of credit protection should be dealt with through the capital planning process rather than artificially via RWA.

2. **<u>Definition of Default</u>** *<u>(page 109)</u>*
   In case banks must use for host supervisory purposes another definition for default than used for consolidated group and internal purposes, compliance with the one obligor, one rating requirement group-wide is impossible. Furthermore, for internationally syndicated loans, it is undesirable that different default definitions apply in different jurisdictions. In addition, there will be issues in the area of cross border rating validation, use test, mapping to external ratings and, for some banks, in the setting of correlation parameters. We believe that the definition of default, that has been discussed intensively prior to the establishment of the Basel Accord, is one of the key elements where regulators need to align with each other.

3. **<u>Supervisory Mapping Function</u>** *<u>(page 120)</u>*
   In case banks are not able to provide own ELGD estimates (downturn), an imposed supervisory mapping function must be used de facto leading to a minimum LGD of 8%. Especially for daily revalued, but not daily re-margined financial collateral, this function is too conservative. Also for back to back facilities, this is overly conservative as cash collateral is not impacted by downturn conditions.

4. **<u>Defaulted Assets</u>** *<u>(page 138)</u>*
   The newly introduced RWA calculation for defaulted assets is effectively ensuring that the RWA result for defaulted assets can never be lower than RWA pre-default. The newly introduced formula has two repercussions: 1. the floor seems to penalize intermediary downgrades prior to default, and 2. upon default suddenly collateral recognition is disallowed. We believe the first issue leads to a disincentive to apply an adequate ratings process. As to the second, we are of the opinion that the formula is conceptually flawed, and recommend to replace LGD with an estimate of the specific recovery of the exposure in question.

5. **<u>Double Default</u>** *<u>(page 81)</u>*
   Double Default may only be used if the US supervisor has given permission. Our opinion is that given that the double default treatment is already rather limitative and that the formula is straightforward, we do not see the rationale why in addition permission must be given. This raises the question whether additional intransparent requirements will be imposed.

6. **<u>Asset Securitization; Securitized Asset Types</u>** ***<u>(page 166)</u>***
For the full securitization treatment to apply, solely financial assets can be securitized assets (i.e. no music and film rights). For non-financial assets, the RBA may apply. But if not rated or no inferred rating available, then capital deduction will be applied, which is extremely severe. We do however not understand the rationale behind the more penalizing capital treatment for non-financial assets.

7. **<u>CRM: Financial Collateral</u>** ***<u>(page 201)</u>***
The highest collateral haircut for investments in funds has to be applied. The impact of this is high as margins in this type of business are often thin. We believe that it would be more appropriate to require banks to apply a weighted average collateral haircut.

8. **<u>EAD for Asset Based Lending</u>** ***<u>(page 123)</u>***
The idea of having the effect of pre-default paydowns recognized is fully supported by us. The impact of this effect can be rather high, provided that banks can validate this by their history. Our experience is that history will prove this indeed.

9. **<u>LGD Floor</u>** ***<u>(page 120)</u>***
The LGD floor indicates that LGD must be at least equal to ELGD. Banks in question will conduct further research on the phenomenon of a negative correlation between PD and LGD. The conservative mapping function is given for the floor. Is this formula coming in place for the margin of conservatism that is currently applicable?

10. **<u>Retail Segmentation</u>** ***<u>(page 172)</u>***
It is stated that retail segments should not cross national jurisdictions. Some jurisdictions are cross-border (e.g. CRD in Europe. We assume that this is more about jurisdiction than nationality. Can the agencies confirm this?
Furthermore, in our opinion it cannot be excluded that in the future in certain Asian countries retail segments cover portfolios in more than one country. Especially asset-based lending (e.g vendor finance) is standard in many Asian countries. In this sense, the statement limits flexibility and good business practice of banks.

11. ***<u>Retail Seasoning Effects (page 115)</u>***
Seasoning effects, if deemed material must be taken into account in retail PD. In our opinion this can be qualified as rather challenging as we believe that this cannot be validated. We therefore propose to make this optional.