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Proposal: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications

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January 18, 2006 Office of the Comptroller of the Currency 250 E Street, SW Public Reference Room Docket No. 05-16 Mail Stop 1-5 Washington, DC 20219 regscomments@occ.treas.gov Robert E. Feldman Executive Secretary Attn: Comments/Legal ESS Federal Deposit Insurance Corporation 550 17th Street, NW Washington, DC 20429 Comments@FDIC.gov Regulation Comments Chief Counsel's Office Office of Thrift Supervision 1700 G Street, NW Washington, DC 20552 Attn: No. 2005-40 regscomments@ots.treas.gov Jennifer J. Johnson Secretary Board of Governors of the Federal Reserve System 20th Street and Constitution Ave, NW Washington, DC 20551 Attn: Docket No. R-1238 www.federalreserve.gov Re: Advanced Notice of Proposed Rulemaking – Risk Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Domestic Capital Modifications Capital, 70 Fed. Reg. 61068 (October 20, 2005) (“Basel IA ANPR”) Ladies and Gentlemen: HSBC North America Holdings Inc. (“HSBC North America”) appreciates the opportunity to comment on the Basel IA ANPR issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the “Agencies”). HSBC North America is a bank holding company that operates various bank and non-bank subsidiaries in the United States and Canada. Our largest bank subsidiary, HSBC Bank USA, N.A., Wilmington, Delaware, operates more than 400 branches, which are located in the states of New York, Florida, Pennsylvania, California, Washington, Oregon, and the District of Columbia. HSBC North America also owns HSBC Finance Corporation, which issues consumer credit cards through HSBC Bank Nevada, N.A., Las Vegas, Nevada, and consumer loans under state licenses. Other subsidiaries of HSBC North America engage in a broad range of financial activities in the United States and Canada. With balance sheet assets of over \$350 billion, HSBC North America will be a “core” bank for purposes of Basel II, and thus required to implement the advanced internal ratings based (“A-IRB”) approach for credit risk and the advanced measurement approach (“AMA”) for operational risk. As such, and as an active participant in the Agencies’ QIS 4 process, HSBC North

America recognizes that the Agencies are concerned with the wide dispersion of capital results reported among organizations and portfolio types measured under Basel II's advanced approaches for purposes of QIS 4. We also recognize the competitive concerns associated with a bifurcated regulatory capital framework that have been raised by a number of constituencies including community and regional banking organizations, trade associations, and lawmakers. These concerns, along with the Agencies' stated desire to improve existing capital standards, appear to have significantly influenced the Agencies' decision to delay the implementation of Basel II in the United States, and shaped the context within which Basel IA was introduced. While not explicitly stated in the ANPR, it appears that the Agencies may intend that Basel IA will become the base capital standard for all US banks, including those banks that will eventually transition to the advanced capital standards under Basel II. As a member of the HSBC Group, our preference would be to implement Basel II according to the current international schedule. However, that not being the case, we are responding to the Basel IA ANPR as if our U.S. operations will be subject to it, and in light of the circumstances that gave rise to its publication.

I. General Comments Scope and Applicability -

We recommend that the revised capital standards resulting from the Basel IA ANPR be the mandatory capital standard for all banks in the United States, replacing Basel I. If this cannot be, we strongly recommend maintaining the existing capital adequacy standards under Basel I while allowing Basel II banks to transition to the advanced risk management approaches per the original Basel II implementation timeframes. The prospect of having, potentially, three different capital adequacy frameworks (Basel I, Basel IA, and Basel II) would not appear to accomplish the Agencies' objectives of leveling the competitive effects of a bifurcated regulatory capital framework. As well, it could weaken the Agencies' efforts to align capital requirements with risk, improve risk measurement and management, and make risk and capital adequacy more transparent, by appearing to allow banks to pick their capital adequacy framework as a matter of convenience rather than risk. Further, as a part of a global banking organization, HSBC North America urges the Agencies to engage much more actively their foreign counterparts in the Basel process on issues surrounding home/host differences. From our perspective, the differences in implementation and supervision of Basel II among the major international constituencies are creating an untenable situation for truly global organizations. Unless the Agencies can realign with their international counterparts, or otherwise resolve the multitude of home/host differences (for example, different definitions of default, different implementation timelines, different levels of supervisory scrutiny, potentially different "base" capital regimes like Basel IA, etc.), the Basel II effort will not achieve its intent, and the introduction of an additional capital adequacy regime in the United States (e.g., Basel IA) will exacerbate an already unacceptable situation.

Balance Risk Sensitivity with Complexity and Burden – We appreciate the Agencies' expressed intentions to make Basel IA a more risk-sensitive capital adequacy framework than Basel I. That said, the final rule should be simpler than what the ANPR proposes. We are concerned that the current data capture and mapping for Basel I, and those being developed for Basel II, will not align with the hybrid structure outlined in the Basel IA ANPR. As a result, in some areas, new data mapping structures would need to be established, in others, additional data detail will need to be captured: for example, general ledger and subsystem data feeding regulatory capital calculations is not consistently kept by credit score or loan-to-value ratio ("LTV"). Bank technology resources are not unlimited, and we are concerned that the work and the costs associated with redesigning the data warehouse to comply with Basel IA could be significant unless the rule is simplified.

Basel II Capital Floors - If the Agencies intend to implement Basel IA for all U.S. banks, we would suggest eliminating the Basel II transition floors and calculations. Regulatory capital for Basel II banks would simply be the amount of capital

required under Basel IA until the Agencies ultimately allow Basel II banks to fully implement advanced approaches for capital adequacy purposes (currently scheduled to occur on or after 2012).

Economic Costs/Consequences Associated with Basel IA - While we support the Agencies' overall goal of creating a more risk-sensitive capital baseline through the revision of Basel I, Basel IA should not be used to overcompensate for current supervisory concerns related to higher risk retail and commercial customers. Capital maintenance is not equivalent to, nor should it replace, a sound risk management program. Nor, as the stable backstop to the risks a bank undertakes, should the capital standard change to reflect the emergence of every new risk and new financial product. The capital standard should not be asked to play the role of Pillar II. More specifically, our fear is that by bluntly raising capital standards for very broad categories of loans, Basel IA would effectively become a tax that further drives the banking industry away from certain business lines. By doing so, Basel IA could reduce credit availability, inhibit product development, and radically increase the cost of credit to segments of retail and commercial customers. In many cases, the affected customers would be ones who already face limited credit options or liquidity. To avoid these unnecessary results, we would suggest that, to the extent the Agencies have specific safety and soundness concerns or recommendations related to nonprime or commercial lending, that these be addressed primarily in guidance or regulations specific to those operations, and, if necessary, through directives related to specific institutions.

II. Specific Comments and Recommendations

A. Increase Number of Risk-Weight Categories for Commercial/non-Retail The current risk-based capital framework has five risk-weight categories, and to better associate credit risk with an underlying exposure, the Basel IA ANPR suggests adding four new ones. The Agencies seek comment on the value of increasing the number of risk-weight categories, whether this value would outweigh associated burden, and whether the suggested categories are appropriate. As noted previously, we support the Agencies' efforts to increase the risk sensitivity of regulatory capital. At the lower end of the risk weighting scale performance data indicates that historical defaults and losses are especially low. To keep the capital calculation a simple change from Basel I, we recommend only one new low risk category (a low risk weighting for A- and above credits). Further, we recommend against higher risk weightings for sub-investment grade credits, unless an appropriate and workable solution for unrated commercial credits can be established.

B. Use of External Credit Ratings To enhance the risk sensitivity of the risk-based capital framework, the Basel IA ANPR suggests broadening the use of credit ratings from a Nationally Recognized Statistical Rating Organization ("NRSRO") to determine the risk-based capital charge for NRSRO-rated exposures. The Agencies solicit comment on the appropriateness of the proposed risk-weight categories, the benefit of such an approach in comparison with any new burden generated, whether there are other methodologies that might be reasonably employed to assign risk weights for rated and unrated exposures. Promoting the use of external ratings as a uniform, commonly available measure of credit risk is positive and, we believe, may appropriately increase the risk sensitivity of regulatory capital measurement. But separate identification of too many ratings categories will increase the cost of data collection and cut against our goal of simplicity. Thus, consistent with our comments in the preceding section, we recommend adding only one new low-risk category, for A- and above exposures. Finally, we recommend against higher risk weightings for sub-investment grade credits, unless an appropriate and workable solution for unrated commercial credits can be established.

C. Expand Eligible Financial Collateral and Guarantors The current risk-based capital framework permits lower risk weights for exposures protected by certain types of eligible financial collateral and limited recognition of guarantees provided by independent third parties. The Agencies are considering expanding: (A) the list of recognized collateral to include short- or long-term debt securities (for

example, corporate and asset- and mortgage-backed securities) that are externally-rated at least investment grade by an NRSRO, or issued or guaranteed by a sovereign central government that is externally rated at least investment grade by an NRSRO and (B) the scope of recognized guarantors to include any entity whose long-term senior debt has been assigned an external credit rating of at least investment grade by an NRSRO. But again, we would limit the additional collateral and guarantees to those noted, and do not recommend any further bucketing using additional differentiation.

D. Residential Real Estate Loans First and second lien residential real estate loans are already subject to the Agencies' Real Estate Lending Standards. For this reason, we recommend that the Agencies leverage those standards to implement simplified and more risk-sensitive capital requirements, rather than creating a new scheme using a wide range of LTVs and credit scores. All banks must already capture the amount of residential loans with LTV's of 90% or higher in order to comply with these standards. As well, virtually all banks consider requiring mortgage insurance when a loan is originated with an LTV in excess of 80%. For mortgages meeting the underwriting and LTV requirements of the Real Estate Lending Standards, we recommend a risk weighting of 20% reflecting their high quality. Mortgages that are prudently underwritten according to the Real Estate Lending Standards, but do not meet the LTV requirements in those standards, would be risk weighted 50%. Those of lower quality and that do not meet the LTV requirements of the Real Estate Lending Standards, would have a risk weighting higher than 50%.

E. All Other Retail Exposures In the Basel IA ANPR, the Agencies also seek recommendations for structuring a risk-sensitive approach to the capital requirements for other retail exposures. We suggest that the table below may be feasible for banks of all sizes to implement, without the system production and data capture that would be required by new loan level LTV and credit score analysis. Basel I applies weights according to whether a loan is "current or less than 90 days past due" or "more than 90 days past due." In essence, our suggestion is to enhance the risk sensitivity of bank capital requirements by introducing two more delinquency buckets. Our approach uses the same risk weight criteria but segments products into "Other Retail," and "Qualified Revolving" exposures, terms that could be defined consistently with definitions included in the Agencies' final Basel II regulation. In the table, risk weights go up from left to right in any row. Similarly, risk weights go up from top to bottom in any column.

Proposed Risk Weights for Retail Loans under Basel IA	Other Retail	Qualified Revolving
Bucket 1	Current	WOB1
Bucket 2	0 < 30 DPD	WOB2
Bucket 3	30 < 90 DPD	WOB3
Bucket 4	=> 90 DPD	WOB4
WQB1	WQB2	WQB3
WQB4		

In establishing the risk weights for the buckets shown in the above table, we would strongly recommend that the Agencies recognize that adequate reserves are retained for each bucket. Further, the amount of exposure to be assigned to any higher risk weight category should be reduced by loan loss reserves directly allocated to cover the exposure.

F. Short Term Commitments Under current risk-based capital standards, short-term commitments are generally converted to an on-balance sheet credit equivalent amount using the zero percent credit conversion factor ("CCF"). As a result, banks that extend short-term commitments do not hold any risk-based capital against the credit risk inherent in these exposures. We agree that the credit risk inherent in short-term commitments, such as those enhancing liquidity to the commercial paper market, should be incorporated into any revised capital adequacy framework. We recommend that Basel IA mirror the proposed risk weights in the Basel II Standard, namely a 20% CCF for exposures outstanding for less than one year and a 50% CCF for those over one year.

G. Commercial Loans 90 Days or More Past Due or in Nonaccrual Existing rules generally weight commercial loans at 100% unless the credit risk is mitigated by an acceptable guarantee or collateral. Because exposures that are 90 days or more past due or are in nonaccrual status often result in a loss to the institution, the Agencies are considering increasing the risk weight of these

exposures. The amount of the exposure to be assigned to the higher risk-weight category would be reduced by loan loss reserves directly allocated to cover the exposure. This proposal raises several concerns that merit fuller discussion and analysis beyond the brief note in the Basel IA ANPR. In particular, questions arise concerning not only the size of this capital impact to the industry, but also the application of risk mitigation and risk measurement, including the function of collateral and guarantees. Furthermore, the assignment of reserves to such exposures must be considered, and subject to explicit accounting rules. If changes are made, a primary objective should be a workable commonality among Basel IA, Basel II, and accounting rules for reserve requirements. But, in light of the on going requirement for adequate reserves, we do not think changes should be made.

H. Commercial Real Estate Exposures The Basel IA ANPR states that, to address certain longstanding supervisory concerns, capital requirements for certain commercial real estate exposures such as acquisition, development and construction (“ADC”) loans merit revision. Specifically, the Agencies are considering assigning certain ADC loans to a higher than 100% risk weight. To promote risk sensitivity, and to avoid discouraging banking organizations from making ADC loans backed by substantial borrower equity, the Basel IA ANPR suggests exempting ADC loans from the higher risk weight if the ADC exposure both (1) meets the Real Estate Lending Standards and (2) the project is supported by a substantial amount of borrower equity for the duration of the facility. The Basel IA ANPR seeks recommendations on improvements to these standards, as well as alternative ways to make risk weights for commercial real estate loans more risk sensitive. To that end, they request comments on what types of risk drivers, such as LTV ratios or credit assessments, could be used to differentiate among the credit qualities of commercial real estate loans, and how the risk drivers could be used to determine risk weights. Consistent with our comments on residential real estate above, we recommend that the Agencies use the existing framework of the Real Estate Lending Standards to create any revisions to bank capital standards. For example, prudently underwritten loans with LTV ratios below the LTV limits required by the Real Estate Lending Standards should receive a lower risk weight than currently required (say a 75% risk weight). Prudently written loans not meeting the existing LTV standards should be risk weighted at 100%, and those of lower quality should have a risk weighting over 100%.

I. Small Business Loans The Agencies are considering lowering the risk weight for certain small business loans from 100% to possibly 75%, for loans under \$1 million on a consolidated basis to a single borrower. Under one alternative, a loan would be eligible for this lower risk weight if it met the bank’s underwriting criteria (including an acceptable assessment of the collateral and the borrower’s financial condition and ability to repay the debt) as well as the following requirements: full amortization over a period of seven years or less, performance according to the contractual provisions of the loan agreement, and full protection by collateral. The Agencies also suggest that eligibility for a lower risk weight could be based on a credit assessment of the business’ principals and their ability to service the debt, where the business principals personally guarantee the loan. The Agencies seek comment on these and other alternative approaches for improving risk sensitivity of the risk-based capital treatment for small business loans, including the use of credit assessments, LTVs, collateral, guarantees, or other methods for stratifying credit risk. We support a lower risk weight for this segment, although the conditions proposed in the ANPR are too complex and would require additional expense to implement. We therefore recommend a risk weight of 75% for exposures under the \$1 million cap.

J. Early Amortization Under the current capital rule, there is no risk-based capital charge against risks associated with early amortization of securitizations of revolving credits (e.g. credit cards). While acknowledging that early amortization events are infrequent, the Agencies recognize that such provisions raise several distinct concerns about the risks to seller banking organizations.

Accordingly, the Agencies are considering several approaches for applying an early amortization capital charge. One option proposed is to apply a flat conversion factor (e.g. 10%) against off-balance sheet receivables in securitizations with early amortization provisions. Another would be to assess capital based on key indicators of risk for such exposures, such as changes in excess spread levels. We agree that capital should be assessed to recognize the risk associated with early amortization provisions. Our preference would be to establish a sliding risk weighting scale that increases as excess spreads narrow.

III. SUMMARY As a member of the HSBC Group, our preference would be to implement Basel II for our U.S. operations according to the current international schedule. However, as that does not appear to be the current intent of the Agencies, we are responding to the Basel IA ANPR as if our U.S. operations will be subject to it. In that light, our recommendations can be summarized as follows. Basel IA should be implemented for all banks in the United States. It should be very simple, correcting the major deficiencies of Basel I. With Basel IA implemented for all banks, including Basel II banks, the Basel II transition floors and calculations should be eliminated. Regulatory capital for Basel II banks would simply be the amount of capital required under Basel IA until the Agencies ultimately allow Basel II banks to fully implement the advanced approaches for capital adequacy purposes (that is, on or after 2012). * * *

We appreciate this opportunity to submit comments on the Guidance, and support the Agencies' efforts to create nationwide standards on these issues. If you should have any questions or comments regarding this letter, please feel free to call me at the number listed below or Martha Pampel, Deputy Regulatory Counsel, at (847) 564-7941. Sincerely, - s - David D. Gibbons Senior Executive Vice President and Chief Risk Officer HSBC North America Holdings Inc. (847) 564-6398

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