

To: Basel II NPR Public File

From: Mark Van Der Weide and Allison Breault

Date: May 31, 2006

Re: Meeting with Citigroup, Inc., J.P. Morgan Chase & Co., and Wachovia Corporation

On May 30, 2006, Governor Bies and Board staff met with representatives of Citigroup, Inc., J.P. Morgan Chase & Co., and Wachovia Corporation to discuss the interagency notice of proposed rulemaking ("NPR") to implement a new risk-based capital framework based on the Basel Committee on Banking Supervision's ("BCBS") Basel II capital accord ("Accord"). The bankers expressed concern that the NPR lays out a capital framework that is overly conservative as compared to the Accord, potentially places U.S. banks at a competitive disadvantage compared to U.S. investment banks and European banks, and imposes significant implementation costs relative to the possible benefits.

The bankers expressed concern that the NPR is overly conservative and not adequately risk sensitive. They asserted that the BCBS revised framework published in July 2004 ("Mid-year Text") was more risk sensitive than the NPR. They cited a preamble statement that "the agencies will view a 10 percent or greater decline in aggregate minimum required risk-based capital ... compared to minimum required risk-based capital as determined under the existing rules, as a material reduction warranting modifications to the supervisory risk functions." This statement, in their view, evinces an agency intent to effectively peg banks' future capital requirements to existing capital requirements. They expressed similar concerns about the proposed 1.06 scaling factor, which is also in the Mid-year Text, which they characterized as an arbitrary mechanism to maintain the level of existing capital requirements. Governor Bies reiterated that the NPR's goal is to better align regulatory capital and economic capital. She noted that the fourth Quantitative Impact Study conducted in connection with the Accord projected a significant drop in capital requirements, and she urged the bankers to consider the preamble discussion of a 10 percent decline in this context. She also urged the bankers to read the whole section, not just the single paragraph discussing possible agency responses to a decline of 10 percent or more in aggregate minimum required risk-based capital. She also noted that the Board intends to propose collecting additional nonpublic data to better evaluate the cyclicity of banks' regulatory capital requirements under Basel II.

The bankers also urged the Board to revise the NPR to more closely track the Mid-year Text. They expressed concern that the NPR does not offer the same capital treatment outlined in the Mid-year Text for lending to small and medium enterprises, pre-existing equity investments, or equity investments in leveraged funds, placing U.S. banks at a competitive disadvantage compared to European banks operating in the United States. The bankers also expressed concern that the NPR's divergence with the Mid-year

Text will provide a competitive advantage to U.S. investment banks that are regulated by the Securities and Exchange Commission (“SEC”) because the SEC’s holding company capital rules more closely track the Mid-year Text. In addition, the bankers expressed concern that the duration of, levels of, and calculation mechanics for the transitional floors differ between the Mid-year Text and the NPR, resulting in a longer and more costly implementation process for U.S. commercial banks.

The bankers expressed further concern that the NPR would not permit U.S. banks to use default-weighted average loss given default (“LGD”) data as inputs into the capital formulas. The bankers similarly described the NPR’s mapping function to convert expected LGDs into downturn LGDs as a diversion from the Mid-year Text that would significantly raise capital requirements under Basel II. They also expressed concern that, under the NPR, the sale of a wholesale exposure at a 5 percent credit loss would automatically trigger the definition of a default.

In addition, the bankers expressed concern that the NPR limits the scope of an eligible double default obligor to nonfinancial firms. The bankers urged that the final rule should provide double default recognition to credit derivatives and guarantees regardless of the nature of the obligor.

Finally, the bankers urged the Board to phase out or change the leverage ratio capital requirement in the wake of Basel II. The banks view the leverage ratio as a competitive disadvantage for U.S. banks.

Board staff urged the banks to submit detailed written comments on the proposal.

The list of attendees included:

Federal Reserve Board:

Governor Susan Bies

Roger Cole

Steve Roberts

Norah Barger

Barbara Bouchard

Mark Van Der Weide

David Jones

Robin Lumsdaine

Laricke Blanchard

David Wright

David Palmer

Allison Breault

James Garnett

David Bushnell

Greg Norwood

Don Truslow

Citigroup

Citigroup

Wachovia

Wachovia

Mike Cavanagh
Don Wilson
Adam Gilbert
Raymond Natter

JP Morgan Chase
JP Morgan Chase
JP Morgan Chase
Barnett Simon Natter