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Date: March 26, 2007

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, DC 20219
Attention: (Docket No. 06-15)
regs.comments@occ.treas.gov

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
Attention: Comments/Legal ESS,
comments@fdic.gov

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave, N.W.
Washington, DC 20551.
Attention: (Docket No. R–1238)
regs.comments@federalreserve.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552
Attention: No. 2006–49
regs.comments@ots.treas.gov

Dear Sir or Madam:

Subject: Submission of comments on Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications; Joint Notice of Proposed Rulemaking

i-flex solutions[1] (hereafter referred to as i-flex) appreciates the opportunity to comment on the proposed revisions to the existing risk-based capital guidelines[2], popularly known

[1] i-flex® solutions is a world leader in providing IT solutions to the financial services industry, with more than 720 customers in over 120 countries. Its range of products, custom solutions and consulting services enable financial institutions to cut costs, respond rapidly to market needs, enhance customer service levels and mitigate risk. Oracle Corporation holds a majority stake in i-flex solutions. The strategic relationship with Oracle provides financial institutions around the world an unmatched, comprehensive and integrated suite of solutions. i-flex has over 8000 employees with special focus on the banking and financial services sector. More than 100 of these professionals concentrate on Risk Management and Basel II. The Basel II Solution of i-flex called Reveleus has been chosen by three of the top-seven banks in the United States -- Citibank, Wachovia Corporation and Wells Fargo -- besides leading institutions such as BMO Financial Group and Lloyds TSB. Apart from our experience in North America, we have executed various engagements in risk management in general and Basel II in particular with banks across Asia, Europe and Latin America. Based on this experience, i-flex has an excellent understanding of the current status of implementation and requirements of Basel II. Additional information about i-flex is available at www.iflexsolutions.com.

as Basel IA. We are confident that our comments will help the U.S. Regulatory Agencies[3] develop a framework that is risk-sensitive as well as practical for financial institutions while achieving their goal of maintaining a stable financial system.

By virtue of being a company that provides consulting, products and software services, i-flex is not directly impacted by the Basel IA capital regulations. However, we strongly advocate sound risk management and appropriate capital measurement – with a view to promote financial stability in the system and also improve performance measurement of banks and financial institutions.

Summary Comments

Excess capital held by Banks:

The impact of Basel IA would be far reaching, with around 9000 banks in consideration varying from small regional banks to large commercial banks with complex operations and products. A general belief is that many of these 9000 institutions maintain capital far in excess of the minimal requirement and may continue to do so. Thus, there would be no material benefit for banks to move towards a more risk-sensitive capital framework like Basel IA.

While the above-mentioned points are true and important, some counterpoints for your consideration are:

a) Excess capital held by banks is no substitute for a more granular measurement of risk. With rapid changes in financial markets and introduction of new and more complex products, banks are faced with increased risks that manifest periodically. The crisis of "savings and loans" companies[4] in the 1980s and the recent sub-prime loan crisis are a case in point. The increase in competition (resulting in lower spreads) and growth ambitions of banks may lead to compromise on asset quality, further reiterating the requirement of a robust risk management system.

b) While most banks adopt prudent approach to risk management, a few banks may have substantial hidden risks or capitalize on arbitrage opportunities offered by Basel I.

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[2] Described in the Joint Notice of Proposed Rulemaking (NPR) of December 26, 2006 and popularly known as Basel IA

[3] The Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation and Office of Thrift Supervision jointly referred to as the Agencies.

[4] The savings and loan crisis resulted in over 1,000 US savings and loan institutions, failing with an estimated loss of USD$150 billion.

Cost for Transition from Basel I to Basel IA

Another well-founded concern of the Agencies is the cost associated with transition from Basel I to Basel IA. The hypothesis is that the transition would be possible with the data available as part of the credit and portfolio management systems, thus reducing the financial burden of the regulation. Our analysis indicates that this hypothesis is not valid because of the use of external ratings and substantial changes required on account of collateral treatment.

Most banks use ratings to supplement their analysis, with ratings being fungible across agencies, maturities and types. Ratings are thus not captured in a structured way as demanded by Basel IA. In addition, rating agencies would charge for periodic and automated rating data dissemination. The application of eligible collaterals to reduce the RWA appropriately would demand investment in suitable systems to ensure auditability and traceability.

Are these costs justified?

The next logical question is "Would the increased costs for Basel IA be justified?" Our analysis indicates that the cost for small and mid-size banks to implement Basel IA would be around 2-4 basis points of asset size and the same should be considered as agency[5] cost. This would also lead to better risk management in banks and a more stable financial system, thus justifying the cost.

Overly focused on estimation of minimum capital

The Basel IA proposals seem excessively focused on estimation of minimal capital requirement. While this is crucial, the estimated capital number would be meaningful only if accompanied by appropriate risk management systems and adequate infrastructure for data accuracy. This requirement is partially met by the periodic supervision of banks by regulators. The Pillar II framework under Basel II would be a good step in this direction. A mechanism to measure and allocate capital for operational risk would also be valuable.

Should we move to Basel II?

Based on the above mentioned points, we would recommend that the Agencies either map Basel IA to the Standardized Approach or accept the Basel II Accord in its totality, thereby giving banks a choice of three methods for credit risk and operational risk. We expect this approach to have the following advantages:

a) The Basel II is the result of extensive discussion and analysis, including quantitative impact studies. This would avoid the US Agencies the burden of evaluating the framework from this perspective.

[5] Agency Cost is the cost that shareholders must incur to monitor the actions of their managerial agents.

b) The standardized approach of Basel II has been tested by numerous banks in Europe and Asia – the US banks could benefit from this experience.
c) There are a few international banks operating in the US, which may not be ready to comply with the advanced approaches of Basel II; but would have to comply with either the standardized approach or F-IRB to satisfy their Home regulator. The usage of the Basel IA for the Host regulator might further complicate the Home Host challenges.
d) While the use of external ratings would be a good starting point, many banks hold assets that are of high quality but are unrated. The standardized approach would result in an unfair treatment to such asset classes. The F-IRB under Basel II helps banks meet this challenge and hence would be appropriate for such asset classes.

Based on the overall philosophy articulated above, we have addressed each of the questions posed:

1. Impact of Basel 1A on banks[6]

i-flex appreciates the Agencies' concern of overburdening banks that endeavor to comply with Basel IA. However, to meet the proposed guidelines and claim a preferred risk weight, banks would have to invest in data management and systems to support this preferential treatment. We mention below some of the areas wherein we envisage additional resources:

a) Re-programming of the current systems to capture more risk categories and remap exposures as per these categories
b) Use of external ratings and mapping these ratings to risk weights. This would involve capture of additional information such as:
    i. Name of the External Credit Assessment Institution (Rating Agency)
    ii. Check for eligibility of rating agency (as defined by the Agencies)
    iii. Type of entity
    iv. Rating symbols
    v. Term of rating - short term or long-term
    vi. Other characteristics: Seniority, security, solicited versus unsolicited, Structured obligation, financial strength rating
    vii. Date of rating
    viii. Applicability of rating on the date of computation of RWA (latest updated rating and check if rating has been withdrawn, etc)
    ix. Methodology and Algorithms to convert ratings into RWA
    x. Capture of sovereign rating (to apply a floor) for unrated obligors.

c) Most regional and community banks do not capture credit rating since only a few of their borrowers are rated. Wherever external credit ratings are used to supplement analysis, they are done so fungibly across agencies, maturities and

[6] Question 1 of the NPR

types and serve as an input to the credit decision process. Ratings are thus not captured in a structured way as demanded by Basel IA.

d) Many banks do not capture collateral information in a format that would enable regulatory supervision. The requirement here (to use collaterals to adjust RWA) is "not to just do it right" but demonstrate that "it has been done right". This requirement would demand investment in suitable systems to ensure appropriate valuation, auditability and traceability.

e) External rating capture and collateral adjustments necessitate capital computation at a more granular loan level unlike Basel I (which was at an aggregated level). This would necessitate mechanisms to reconcile book of accounts with the loan system – resulting in additional investments.

f) Mechanism to compute LTV-based risk weights will have to be introduced for first lien and sub-ordinate liens adding additional burden

g) Credit conversion factors table for various categories like early amortization of securitization of revolving credits will need to be introduced

The extent of changes described would depend on the extent to which a bank decides to use the preferred risk weights. If a bank decides on taking advantage of the preferential risk weights, the above changes would involve additional resources in terms of manpower costs, top management oversight and commitment and change in systems. Thus, Basel IA would definitely burden an organization both financially and from a management commitment perspective. The trade-off would be a more granular measurement of risk and the costs should be seen in the light of benefits that Basel IA would provide over the long term.

2. Opt-in and Opt-out Option for Banks[7]

As mentioned earlier, banks that do not plan to use the preferred risk weights based on external agency ratings or collaterals would need to make a few modifications to comply. Thus, the Basel IA regulations, under certain boundary conditions, would mimic Basel I (albeit with some additional risk categories)[8]. **This would be possible if the Agencies allow banks to use the entire menu of alternatives available under Basel IA**. This means that banks may implement Basel IA on a selective basis – utilizing the advanced options of Basel IA for some categories of assets and the simpler options for asset categories that would require substantial effort. A Pillar II type mechanism could be used to ensure that banks do not 'cherry pick' methodologies to obtain favorable capital treatment. This approach would give banks the time needed to transition to the new approaches and develop the processes and data to support them.

Given this backdrop, all banks can transition to Basel IA – with the choice of using the preferential risk weights to reduce capital. Banks that believe that they would not gain

[7] Question 2 of the NPR

[8] In the Basel II Accord, the "Simplified Standardized Approach" endeavors to do the same.

any advantage by using preferential risk weights can follow the simplified Basel IA approach that is very close to Basel I. Thus, banks should not be given an option to "Opt In" it should be made mandatory for all banks. We fully appreciate the need for an exit option for "Opt In" banking organizations to Basel IA. Given the above approach, the option to "Opt Out" would not be required. Further, any "Opt Out" feature would pose its own operational challenge for banks as well as regulatory agencies.

Given the operational challenges that banks might face in terms of understanding/interpretation of the new rules, proper implementation of the proposed changes and overall successful migration to Basel IA, the Agencies must provide banking organizations with a reasonable transition period of one to two years to move to Basel IA.

3. New Risk Weight Categories Considerations[9]

The number of risk categories should be decided such that there is meaningful differentiation based on the risk profile. The risk categories should have low standard deviations within each group and high deviation across groups. The entire risk categorization structure must provide some mapping to the risk categorization of the banks. Our analysis indicates that banks currently use more risk categories (than the eight categories being proposed by Basel IA) to classify their assets. Hence, the Agencies should consider more risk categories and hence risk weights.

An appropriate way to arrive at the number of risk categories is to survey the banks involved. The survey can also be used to evaluate the appropriateness of the 10% and 200% risk weights.

4. Proposed Use of External Ratings[10]

i-flex supports the use of external ratings for direct exposures, recognized collateral and eligible guarantees as described in the NPR document. However, many of the regional and community banks do not have many exposures, collaterals or guarantees that are rated. To the extent that assets are rated, use of external ratings might help increase risk sensitivity. Having said this, this also leads to a scenario wherein there is no mechanism to differentiate risks of unrated companies. The F-IRB approach under Basel II would help overcome this anomaly.

[9] Question 3 in the NPR
[10] Question 4 in the NPR

5. Financial Strength Ratings to Determine Risk Weights for Exposures to GSEs[11]

Financial strength ratings are issuer ratings and indicate the overall financial condition, safety and soundness excluding parameters like external support. Hence, they do not reflect the debt repayment ability of the bank. These ratings are also not included in the transition matrix of nationally recognized statistical rating organizations (NRSROs). Hence, financial strength ratings are not good substitutes for debt ratings.

Most government-sponsored entities (GSE) in the US have great flexibility and credit enhancements by virtue of their design; this may not be captured in the financial strength rating. Further, some GSEs may be of equally high credit quality but may be unrated. The Federal Home Loan banks are a case in point. Based on these considerations, i-flex would recommend continuation with the existing framework of assigning a 20% risk weight to GSEs.

6. Usage of External Ratings for Public Sector Entities [12]

Public Sector Entities should be linked to risk weights and can be given a risk grade that is one notch lower than the risk grade applicable to its sovereign similar to Option I applicable for Banks in standardized approach in Basel II.

7. Use of LTV and Other Risk Drivers to Improve Risk Sensitivity[13]

The use of LTV would definitely enhance the risk sensitivity of first lien mortgages over the current rules. Besides LTV ratios, banks use other parameters for credit assessment like credit scores and credit assessments. Also, seasoned loans are observed to have lower default rates. Hence, the capital estimation process may be more meaningful if some of these factors are incorporated.

In some sense, the three factors described, namely, credit score, LTV and seasoning are akin to the probability of default, loss given default and maturity for corporate loans. In the standardized approach of Basel II, PD is approximated by credit ratings and LGD through empirical observations. A similar methodology could be adopted for mortgages – mapping of credit scores to risk weights and mapping of LTV to LGD.

From a conceptual perspective, mapping of credit scores to ratings is quite straightforward. This would involve approving a few credit scoring agencies and laying down guidelines about usage. Some of the methodologies developed for dealing with multiple rating agencies for corporate loans could be used.

The computation of loan to value ratio from an "economic" perspective would be a challenge since loan value as well as value of property are variables. The loan value

[11] Question 5 in the NPR

[12] Question 6 in the NPR

[13] Questions 7, 8, 9 and 10 in the NPR

change is captured by the back office/credit risk systems of banks, whereas the property value change is not normally captured. It would also be an additional burden on banks to capture property values periodically.

A solution to this could be to err on the side on conservatism, that is, recognize any fall in property price while ignoring gains. Instead of each bank valuing all properties, a property index (similar to the Public Securities Association index for pre-payments) could be used. This would factor in specifics of a particular region/geography that can be adjusted, with the exercise being carried quarterly or annually.

The LTV ratio captures the residual maturity of the performing mortgage loan to a certain extent. Further, any attempt to factor seasoning or maturity in the capital computation model would burden the banks without offering any substantial benefit.

8. Treatment for Private Mortgage Insurance Providers[14]

Private Mortgage Insurance (PMI) does provide additional security and must form part of the capital estimation process and offer relief. Certain criteria may be laid down. For example, providers must be non-affiliated companies of the banking organization. Besides, the PMI value should be adjusted downward, considering the insurer financial strength and presence of any insurance caps or deductibles. The adjusted value may further be given a haircut on claim success expectations. The final value of PMI may be deducted from the LTV to assign risk weights.

9. Treatment of Non-Traditional Mortgage[15]

Non-traditional loans like "mortgage loans with negative amortization" should receive a higher risk weight than traditional loans, since they are more vulnerable to changes in property values and economic downturn. We agree with the Agencies that the unfunded portion of mortgage loans with negative amortization should be risk-weighted consistent with the risk-based capital treatment for other unfunded commitments.

10. Proposed Risk-based Capital Treatment for HELOCs [16]

We agree with the philosophy proposed by the Agencies that risk weights should apply to both the funded and the unfunded portions of a Home Equity Line of Credit (HELOC). We also agree that the unfunded exposure that is unconditionally cancelable and has a maturity of less than a year should attract a CCF of 0%. However, the risk weights for other categories may have to be re-examined.

[14] Question 11 in the NPR
[15] Question 12 in the NPR
[16] Question 13 in the NPR

11. Risk Weight for a Junior Lien Mortgage[17]

We agree that a junior lien should attract a higher risk weight. i-flex would recommend the following:

a) A mechanism to use credit score along with LTV and type of lien (first or junior)

b) A separate set of risk weights for first and junior lien (irrespective of whether it is the same lender or a different lender) to ensure that the lender is not discouraged to lend against the second lien from a capital perspective.

12. Alternative approach that would apply 20% to all Commitments to a Single CCF[18]

We believe that this approach is not appropriate. It may simplify the capital estimation process but may not foster a better risk-sensitive classification. Further, it may encourage "gaming" of the system.

If CCFs are used, the CCF for short-term and unconditionally cancelable commitments may continue at 0%. But the CCF for all other commitments should be risk-weighted more granularly based on the term of commitment.

13. Securitizations with Early Amortization Triggers[19]

Securitizations with early amortization structures are exposed to higher risks and hence should attract a higher risk weight. The Basel II approach is to assign a risk weight based on the excess spread trapping point ratio; the trapping point being defined at 4.5%. We recommend that this method be allowed under Basel IA. A simpler method of using CCFs should also be allowed.

14. Treatment of Small Business Loans[20]

i-flex agrees with the reduced risk weight of 75% for small business loans that meet the prescribed conditions. However, the size of 1 million USD may be restrictive.

[17] Question 14 in the NPR
[18] Question 15 in the NPR
[19] Question 16 in the NPR
[20] Question 17 in the NPR

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15. Treatment for Other Retail Exposures[21]

Most practices used to estimate capital for mortgages can be used for other retail assets with some modifications. As a first step, use of credit scores in the assessment of retail assets and inclusion of LTV (where possible) would go a long way in meaningfully differentiating credit for retail loans. Unsecured retail exposures should carry a higher risk weight.

16. Options to Alternative Approaches for Basel II Banking Organizations[22]

The Basel II banking organizations (mandatory as well as the opt-in banks) have complex balance sheets and hence the A-IRB approaches would be commensurate with the level of complexity for most asset categories in the balance sheet. However, there are a few asset categories in the Basel II banks, wherein the Basel IA framework would suffice. Thus banks should be allowed the choice of A-IRB for complex asset categories and Basel IA framework for simple asset categories. For assets where the bank decides on a Basel IA framework, the Agencies may make it mandatory for banks to defend their decision.

In the scenario of the Basel II banks being allowed the option of Basel IA for estimating the minimum capital, the pillar II framework and especially the economic capital framework of banks should be used for capital estimation. This implies that Agencies would have to invest sufficient time and staff resources to evaluate the economic capital models.

We suggest that Basel I and not Basel IA framework may be used to compute the floor for Basel II capital. The Basel IA framework involves substantial effort and would also not be commensurate with the capital relief available to banks.

17. Inclusion of Capital Charge for Operational Risk[23]

We also recommend that operational risk capital charge and an assessment of the same are included in the Basel IA framework. This should include a mechanism for quantifying operational risk as well as a Pillar II type framework that checks if the capital assessment is appropriate. For non-Basel II banks, we would recommend either the basic indicator approach or the standardized approach. In cases where the bank does not have sound operational risk practices, additional capital can be demanded by the regulators.

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[21] Question 18 in the NPR

[22] Questions 19, 20 and 22 of the NPR

[23] Question 20 of the NPR

Conclusion:

i-flex strongly supports the endeavor of the Agencies to develop a more risk-sensitive framework for capital estimation. The proposed Basel IA framework is a positive step towards addressing this. However, we strongly recommend acceptance of Basel II proposals in their entirety. This would offer banks an entire menu of choices and help overcome several challenges posed by Basel IA. The national discretion facility available under Basel II will also help to refine the rules further so as to meet the unique needs of thousands of banks in the United States.

i-flex appreciates this opportunity to comment on the Basel IA NPR and would like to be of any assistance to the Agencies on this important issue. Please do feel free to contact me at vijay.sharma@iflexsolutions.com or Ravi Varadachari at ravi.varadachari@iflexsolutions.com or call us on 917-502-9480.

Sincerely,

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