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July 31, 2003

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Mr. Robert E. Feldman
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Attention: Comments/OES
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Re: Basel Committee on Banking Supervision Consultative Paper No. 3 on a New Basel Capital Accord; Comments Requested by July 31, 2003

Ladies and Gentlemen:

On April 24, 2003, the Basel Committee on Banking Supervision published a Third Consultative Paper (CP3) on revision of the International Capital Accord (New Accord). The American Bankers Association[1] (ABA) supports the goals of the revision:

- to better align regulatory capital standards with the underlying economic risks incurred by a banking firm,
- to encourage better risk measurement and management, and
- to promote international consistency in regulatory standards.

We support the intent to establish capital regulations that not only encompass minimum capital requirements but also include supervisory review and market discipline in a comprehensive approach to regulation of risk-based capital.

ABA also appreciates the open and interactive dialogue that the Basel Committee has conducted with the banking industry in this revision. We believe that the

[1] The American Bankers Association brings together all elements of the American banking community to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings institutions, trust companies, and savings banks – makes ABA the largest banking trade association in the United States.

Basel Committee, as a result of listening to the industry, has significantly improved the proposed Accord as presented in CP3. The latest version has addressed many of our banks' concerns with the Second Consultative Paper.

On July 11, the banking agencies in the United States (Agencies) adopted an Advance Notice of Proposed Rulemaking (ANPR) on how the New Accord would be implemented in the United States. As proposed, the United States would apply only the advanced internal ratings-based approach (AIRB) out of the New Accord and only to a core group of the largest, internationally active banks. Additionally, the agencies have requested comments on a number of questions about the proposed New Accord, and have advised that they will not finalize work with the Basel Committee until they have reviewed and analyzed comments on the ANPR. (Responses are due by November 3.) Therefore, we have limited our comments to the AIRB part of CP3 and those other parts that will be implemented by the Agencies. We will reserve some comments for the Agencies when we respond to the ANPR.

Comments

While U.S. banks generally support the progress made in CP3, we still harbor concerns over some specifics of the proposal. The following concerns are discussed in more detail below:

- The collective conservatism in CP3 raises the proposed capital requirements above the goal of true minimum standards.
- Under the AIRB approach, an institution's regulatory capital should be determined solely using internal models, regardless of risk type – *i.e.*, for credit, market and operational risks – subject to supervisory oversight.
- The AIRB approach should not specify limits for parameters.
- Regulatory capital should be required only for Unexpected Losses, not for Expected Losses.
- If Expected Losses continue to be included, then the definition of capital should be changed to include more loan loss reserves in Tier 1 and to allow more than 75% of future margin income as offset to Expected Losses.
- For operational risk, CP3 should be amended to assure (1) full recognition of risk mitigation, (2) uniform examination procedures, and (3) reasonable data requirements.
- The capital treatment of highly volatile commercial real estate is still too onerous.
- The securitization framework remains highly complex and potentially quite burdensome.
- CP3 inadequately considers the full economic benefit of risk mitigation and diversification
- The treatment of credit hedging should be modified to recognize (1) the lower risk of joint default and (2) to relax the overly conservative rules on maturity mismatches.
- Transparency of the supervisory standards for requiring additional capital under Pillar 2 needs to be improved.
- Before requiring additional disclosures, we urge coordination with non-bank, financial regulatory agencies and consultation with equity and fixed-income analysts. New disclosure requirements should wait for rulings from the Securities and Exchange Commission and International Organization of Securities Commissioners.
- The Basel Committee should adopt the principle of lead supervision, where a single regulator, usually in the institution's home country, would be responsible for the global supervision of the institution.

- The timeframe is very tight for implementation by 2007.

Pillar 1

The New Accord will allow qualifying institutions to calculate minimum capital requirements using their own internal risk measurements. This process will incent banks to improve risk measurement, management and mitigation tools.

<u>The collective conservatism in the New Accord raises the proposed capital requirements above the goal of true minimum standards.</u> U.S. banks are unanimously concerned about the cumulative effects of conservative decisions that move the Accord away from being true minimum standards, with Pillar 2 to handle any additional risks. Moreover there is no allowance for diversification across business lines (*e.g.*, with deconsolidated insurance), asset classes (*e.g.*, retail and wholesale portfolios), risk types (credit, market and operational) or geographically. (Diversification needs to be fully and explicitly incorporated into the New Accord.) And risk mitigation is not given sufficient weighting. In totality, the effect is to raise capital requirements above what is needed for safety and soundness to the detriment of bank credit and services.

Examples of collective conservatism include:
- The losses given default (LGDs) on residential mortgages must be at least ten percent.
- The capital requirements for retail exposures (mortgages, revolving credits and non-mortgage non-revolving credits) are too high (primarily due to the inclusion of Expected Losses, discussed below) and the Asset Value Correlations to default probabilities are also too high.
- The risk-reduction benefit for guarantees through "joint probability of default" is only partially recognized.
- Strict matching is required for risk-reduction provided by credit default swaps.
- The 99.9 percent confidence levels for credit and operational risk models equate to an investment grade or "well capitalized" target level of capital, rather than a minimum standard.
- The twenty percent limit on insurance-related capital benefits for operational risk is unnecessary.
- The regulatory capital benefit for Future Margin Income ("FMI") is limited to 75 percent for qualifying revolving retail exposures.
- The floor capital charge in the SFA for securitizations is too high and does not take structural mitigants into account.

<u>The Accord should implement a full internal models-based approach for regulatory capital.</u> While CP3 is a major improvement over the original Accord, our banks generally agree that the proposed AIRB approach falls short of achieving a minimum risk-based capital standard. Use of the proposed computation methods would result in a regime that falls short of achieving truly economic-based regulatory capital.

Our banks recommend that, under the AIRB approach, an institution's regulatory capital should be determined solely using internal models, regardless of risk type – *i.e.*, for credit, market and operational risks. Naturally, supervisory oversight would be required. In CP3, while there are components with the internal models-based approach for equity exposures, the existing market risk capital process, and now in the Advanced Management Approach (AMA) for operational risk, there remain a number of areas in which such an approach is not supported.

We urge full implementation of the internal models approach, especially for credit risk. Credit risk data and quantification techniques are well developed, yet CP3 provides a great deal of conservative prescription. Meanwhile, operational risk, a discipline very much in its infancy, allows for, and even encourages, a bank-developed AMA. While we think this is the correct approach, the conservatism in the credit risk side seems counterproductive.

<u>The AIRB approach should not specify limits for parameters</u>. The Basel Committee should remove the floors and ceilings (especially in retail) and fixed values (especially in retail and corporate) for parameters in banks' internal models. Instead, these values should be determined empirically by each institution.

Arbitrary minimums discourage institutions from measuring or managing risk closely. On the other hand, supervisory review and validation of bank PDs, LGDs, and EADs – a prerequisite for the use of internal data in the regulatory capital calculations – provides sufficient oversight without arbitrary minimums and maximums. During this review process, concerns surrounding assumptions and data calculations will be raised and dealt with. If during this process examiners conclude that a bank has not shown proper back-up for its inputs, they can require additional conservatism in the parameters.

<u>Regulatory capital should not be required for Expected Losses.</u> The New Accord sets capital requirements to cover both Expected Losses and Unexpected Losses. However the definition of capital is not changed to reflect the provisioning that supports Expected Losses and the margins that act as additional buffers against losses. This approach requires banks to reserve twice against Expected Losses: once with loss provisions out of income and product pricing, and a second time with capital. The double-reserving will force banks to cut back on and/or increase charges for lending to non-prime borrowers; these borrowers will be unduly disadvantaged as a result.

Additionally, the New Accord has had to incorporate "work arounds" to insure that capital is not required where reserves have already been established, through the incorporation of Expected Losses, to absorb losses. CP3 includes Expected Loss in the risk-weighted assets denominator of Tier 1 and Tier 2 capital ratios but only partially incorporates reserves in the capital that qualifies for the numerators – loss reserves may only be included up to fifty percent of other capital. The partial recognition in the numerator with full recognition in the denominator distorts the measurement of capital adequacy.

We continue to urge that the regulatory capital methodology be revised to acknowledge the validity of reserves and to apply capital charges only for potential Unexpected Losses. However, if the final Accord continues to cover both Expected and Unexpected Losses, then two additional changes are needed:

- All of the reserves should be recognized as regulatory capital. One hundred percent of loan loss reserves should count as Tier 1 capital rather than just counting as Tier 2 capital. Further, the fifty percent cap and the 1.25% of risk-weighted assets cap on inclusion of loan loss reserves in the current definition of regulatory capital should be removed.
- The Accord should allow a credit to regulatory capital that reflects an institution's earnings. The "future margin income" should be allowed to offset, without limit, the capital charge for Expected Losses; the proposed limitation of the offset (three-quarters of Expected Losses) should be eliminated.

<u>Operational risk</u>: CP3 offers more flexibility in determining regulatory capital for operational risk than the First or Second Consultative Papers. Some U.S. AIRB banks are satisfied that the rules are now more acceptable with the Advanced Measurement Approaches (AMA) framework. Other U.S.

AIRB and non-AIRB institutions are not satisfied with this approach. The institutions that are not satisfied feel strongly that the explicit capital charge for operational risk should be removed from Pillar 1 and incorporated into the assessment of this risk under Pillar 2 Supervisory Review. They feel that the current state-of-the-art for operational risk measurement has not progressed sufficiently to warrant its use in regulatory capital standards.

However, all of our banks - those satisfied with a Pillar 1 treatment and those opposed - appear to generally agree that if the application proceeds, then it should be amended to assure (1) full recognition of risk mitigation, (2) uniform examination procedures, and (3) reasonable data requirements, as discussed below.

The industry has received repeated oral assurances that risk mitigation for operational risk will not be limited to insurance products but will embrace any legitimate risk transfer technique that is developed. However, CP3 identifies only insurance as an acceptable risk mitigant. The New Accord needs to explicitly state that all risk transfer techniques will be considered.

ABA has recommended that the Agencies develop operating risk examination procedures that are applied consistently within and between regulators in advance of final implementation. The Agencies have taken a major step towards meeting that recommendation with the release in the ANPR of the "Supervisory Guidance on Operational Risk Advanced Measurement Approaches for Regulatory Capital." We have just begun to analyze this document and so will reserve further comments for the ANPR.

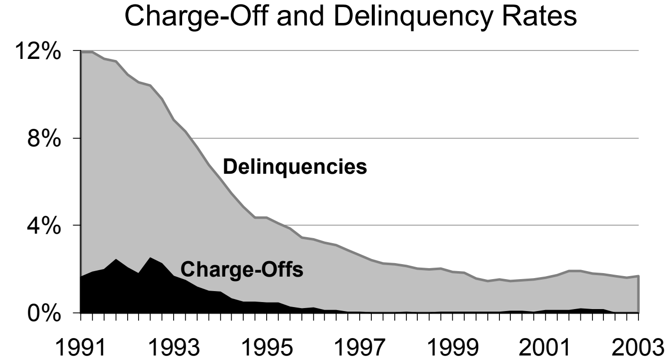
Our member banks understand that there is a range of data relevant to operational risk, including internal data, external data, scenario analysis and qualitative adjustments. However, some have questioned whether all of this data is fully relevant in the capital allocation methodology of each bank. We recommend, instead, that institutions be allowed to use the subset of this data that is appropriate to their own individual situations, subject to supervisory review.

Institutions must not be required to capture, as operational losses, data that is already being captured and capitalized as credit or market risk. The boundaries between operational risk, credit risk and other risks should be well defined. "Legal risk" should be clearly defined.

<u>The capital treatment of highly volatile commercial real estate is still too onerous</u>. CP3 reduced capital charges for highly volatile commercial real estate from the prohibitive levels of the Second Consultative Paper and the Technical Guidance of the Third Quantitative Impact Study (QIS3). However, minimums remain above levels U.S. banks use for internal economic capital purposes.

In CP3, AIRB banks can use the corporate asset risk class formula to determine risk weights for commercial real estate, classified either as income producing or high-volatility (HVCRE). However, for HVCRE a substitute asset correlation formula is required in place of the asset correlation function currently assigned to the corporate risk class formula. The Basel Committee required the substitute, warranting higher correlations and capital charges, based on concerns that, in the past, commercial real estate has at times suffered systemic downturns.

US Bank Commercial Real Estate
Charge-Off and Delinquency Rates



Data from the Federal Deposit Insurance Corporation

ABA recommends that this premise be reviewed. Commercial real estate has become less volatile over the last decade. The change is due to stronger underwriting, including more borrower equity and better appraisal procedures and credit scoring. This fact has been confirmed by the industry's reduced loan loss experience over the last decade (see chart). Moreover, securitization of commercial mortgage-backed securities (CMBS) has improved discipline, transparency and liquidity in commercial real estate lending.

ABA recommends that the certification process for the use of bank-specific parameters be no different than for corporate exposures. We further urge that all commercial real estate should be categorized as income producing, eliminating the HVCRE category.

<u>The securitization framework remains highly complex and potentially quite burdensome</u>. The capital requirements are unduly conservative relative to the associated retained risks, particularly for liquidity facilities for ABCP conduits. Under the AIRB approach, institutions should use internal ratings to determine risk weights, especially for credit enhancements and ABCP conduits.

<u>CP3 inadequately considers the full economic benefit of risk mitigation and diversification</u>. For credit risk, the substitution approach does not recognize the lower risk of joint default and joint recovery and accordingly does not appropriately reflect the risk of these transactions. The treatment of credit hedging should be improved significantly by recognizing the lower risk of joint default and by modifying overly conservative rules on maturity mismatches.

CP3 recognizes credit risk hedging and guarantees by substituting the default probability of the guarantor for that of the borrower when the determining risk weight. However, both the obligor and guarantor must default for an institution to experience a loss on a hedged exposure, and even in this case the institution can seek recovery from both counterparties. The New Accord should recognize the lower probability of joint default and loss-given default of joint recovery. Institutions should be permitted to calculate joint default probabilities using the same correlations as elsewhere in the regulatory framework for corporate exposures (*i.e.*, twenty percent). A joint LGD is appropriate if an institution can pursue recoveries from both counterparties.

The treatment of maturity mismatches is unduly conservative and unnecessarily complex. The proportional adjustment mechanism is far more conservative than the treatment of maturity for corporate exposures. There is no reason to implement two separate sets of maturity adjustments. Instead, maturity mismatches between credit hedges and the underlying assets should be treated as a forward credit exposure using the AIRB approach, with a capital offset for the hedge. The counterparty risk should be reflected as an exposure with joint default probability and recovery.

Contrary to CP3, the New Accord should recognize the benefit of the hedge with maturity less than one year when the maturity of the hedged asset is longer than one year. The value of the hedge declines – but does not disappear – as it approaches maturity. We recommend that the risk associated with the shorter maturity be calculated using the corporate AIRB risk weighting function with a maturity adjustment.

For operational risk, there is inadequate credit for risk mitigation. CP3 allows limited benefit from insurance programs and does not recognize other legitimate, developing risk transfer techniques – *e.g.*, catastrophe bonds. To flexibly allow for new risk mitigation devices and encourage best practices in operational risk management, the proposal needs to be revised to allow institutions to assess operational risk mitigation internally, subject to supervisory review.

In a broader sense, diversification is an important and effective risk-mitigation technique. The New Accord needs to acknowledge and provide lower capital charges for diversification in the broadest sense. This will encourage sound risk management and lower overall risk exposure.

Pillar 2

<u>Transparency of the standards for requiring additional capital needs to be improved</u>. There are no precise guidelines in CP3 for when an examiner should raise the capital requirements for a bank or by how much. On July 7, the bankers' associations of the G-10 countries, including the ABA, submitted to the Basel Committee a letter detailing concerns over Pillar 2's perceived lack of transparency in standards and procedures for allowing supervisors to require additional capital. Mr. Caruana responded on July 25 stating that further explication of the principles of Pillar 2 will be given soon. However, our banks remain apprehensive that Pillar 2 will only be used to raise capital requirements above the Pillar 1 minimums and will never be used to lower capital requirements when warranted. Further, as noted in our letter, all of the G-10 Banking Associations are concerned about differences in application between countries.

Since Pillar 2 gives examiners the discretion to raise capital requirements, we feel the Agencies need to develop guidance, direction and training to ensure objective assessments. In addition, underlying principles must be consistently applied across the supervisory agencies, as well as within a particular agency as it reviews individual banks. Just as regulators want banks to be more transparent, we believe the regulatory process that leads to a demand for more capital under Pillar 2 also needs to be much more transparent.

Pillar 3

ABA supports the Basel Committee stance on the importance of market discipline and believes that disclosure of all relevant information plays an important role. However, transparency is better achieved by the clear presentation of important information than by dissemination of large amounts of hard-to-interpret data.

Our institutions believe that Pillar 3, while significantly improved in CP3, remains too burdensome and detailed. Pillar 3 would require detailed disclosure of risk profiles, especially for the credit portfolio. Banks that show a risk profile significantly worse than their peers, even if returns are greater, may well be punished by the market as outliers; consequently they may be driven away from lending to lower-rated borrowers. The additional disclosure will also require a new reconciling event for banks and the investment community, since no two banks will use exactly the same rating system. The risk of misinterpretation of the required information and the burden its distribution will place on banks far outweigh its potential benefit.

We recommend that the Basel Committee remove from the final rule the proposals in CP3 Table 6(g) for quantitative disclosures of estimated *versus* actual credit risk statistics. Until banks and supervisors have learned from actual implementation experience whether this data is meaningful in the context and format of public disclosure, disclosure of this data should not be required.

Before requiring additional disclosures, we urge coordination with non-bank, financial regulatory agencies and consultation with equity and fixed-income analysts. New disclosure requirements should wait for rulings from the Securities and Exchange Commission and International

Organization of Securities Commissioners. Ultimately, we recommend that the Basel Committee, working closely with the industry and investor community, identify a subset of key disclosures that will appropriately convey an institution's risk profile without inundating the market with irrelevant and uninterruptible information. Remaining disclosures should be left to the judgment of each institution based on the demands of investors.

Competitive Concerns

U.S. banks are very concerned about competitive disadvantages that may result from the New Accord. They are particularly apprehensive about non-bank financial institutions and foreign bank affiliates. Many non-banking financial and even commercial firms offer banking services (*e.g.*, GMAC consumer credit and home mortgage lending) but are not subject to the capital rules. U.S. affiliates of foreign banks may similarly operate under more favorable rules if their national regulator interprets the New Accord to their favor. We note that U.S. regulators tend to take a more conservative approach, as demonstrated by the fact that U.S. banks are effectively required to hold considerably more capital than the minimum under the current or future Accord in order to qualify as "well capitalized" under U.S. law.

Additionally, the complexity of the new rules poses a particular challenge for institutions operating in and regulated by multiple countries. We recommend that the Basel Committee adopt the principle of lead supervision, where a single regulator, usually in the institution's home country, would be responsible for the global supervision of the institution. This approach should enhance cooperation among regulators by requiring more communication across borders and the delegation of responsibilities by the lead supervisor. For the supervised institutions, this approach would prevent duplicate reviews and conflicting requirements from different regulators.

The U.S. bank regulatory agencies have indicated that the full rules will be applied only for 10–12 large U.S. banks that will be required to operate under the AIRB structure – although another dozen may elect to do so by 2007 or soon thereafter. The results of last fall's QIS3 on these institutions suggest that these banks may be able to significantly lower their capital charges. This will mean that, for the same credits, the AIRB banks will have significantly lower capital requirements than other U.S. banks. The heads of the Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation have expressed concerns about potential competitive impacts. These concerns have led to hearings in Congress. Moreover, the U.S. regulators have indicated that they will phase in over two years reductions of capital requirements, giving them time to assess the impacts on competitiveness, safety and soundness. The AIRB banks point out that there will be significant administration and supervisory costs to achieve AIRB status, mitigating any advantages. They feel that the delay in reducing capital requirements is not warranted. While this is not of direct concern to the Basel Committee, it is (or should be) of direct concern to U.S. regulators. We will attempt to address this issue more thoroughly in our comments on the U.S. ANPR.

Implementation Concerns

As our banks consider the practicalities of implementing the New Accord, they are growing concerned that the implementation timeframe is very tight for implementation by 2007 (as will be required in the United States). This is partly because the system requires three years of past risk data, which means that data collection must begin next year to be implemented in 2007. As part of this data gathering process, our banks have authorized ABA Surveys and Statistics to begin an operational risk database. Therefore, data collection methods have to be finalized, to supervisors' satisfaction, by the end of this year. This timeframe will be very difficult to achieve, given that U.S. regulators have only recently released their first thoughts on how the New Accord will be implemented in this country. We understand that other of the G-10 national bankers' associations are also concerned about the current implementation timeframe, and we believe that the Basel Committee will need to continuously monitor implementation by banks with an eye to delaying the implementation.

Finally, as the Basel Committee concludes its work, we believe that many elements of CP3 codify best practices for financial institutions. However, to satisfy all the proposed requirements, institutions will need to add infrastructure that cannot be leveraged to improve management practices or enhance shareholder value. Some parts of the proposal are even at odds with some institutions' internal risk management processes. We believe that regulation should not be so prescriptive and inflexible that it undermines the continuing evolution of risk management. Instead, regulation should be flexible enough to accommodate the development of financial products and risk mitigation techniques. Decisions concerning the form, structure and prioritization of risk management processes and system enhancements should be left to individual institutions.

We urge the Basel Committee to pursue this more principles-based approach and to further reduce the level of prescription throughout the Accord. Rather than detailed Pillar 1 requirements, supervisors should establish strong guidance and outline the principles for risk management policies and practices in Pillar 1. Standards for the internal models should be unambiguous and the models should be subject to rigorous supervisory verification under Pillar 2. This will establish a nimble and risk-sensitive approach that can appropriately reflect each bank's unique risk profile and may be quickly adapted as the financial products and risk management techniques evolve.

Sincerely,

Paul Alan Smith

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