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Via email

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Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
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Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th St. & Constitution Ave., NW
Washington, DC 20551

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Re: Risk-Based Capital Standards: Advanced Capital Adequacy Framework; 71 Federal Register 55830; September 25, 2006; FDIC RIN 1550-AB56, FRB Docket No. R-1261, OCC Docket No. 06-09, OTS Docket No. 2006-33

Ladies and Gentlemen:

The American Bankers Association ("ABA") appreciates this opportunity to comment on rules proposed by the Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision ("Agencies") to implement in the United States the Advanced Approaches from the international Basel II Framework ("Framework").[1] On behalf of the more than two million men and women who work in the nation's banks, ABA brings together all categories of banking institutions 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 associations, trust companies, savings banks, and bankers banks – makes ABA the largest banking trade association in the country.

ABA continues to support introduction of the Framework in this country as an alternative to the current risk-based capital standard. We agree with the Agencies' assessment that the current standard is outdated for many institutions. We support the

[1] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, June 2004 (www.bis.org/publ/bcbs128.pdf).

fundamental principles of the Framework, to promote international consistency of banking standards, robust risk management for banks, and regulatory capital that is sensitive to risk exposures. However, we find that the proposed rules are inconsistent with the Framework in a number of key dimensions. In order for the U.S. rules to be consistent with the Framework's principles, the Agencies need to adhere more closely to the international accord.

ABA has discussed the proposal with representatives from all of the banking organizations that would be required to adopt the Framework's Advanced Approaches (so-called "core" organizations) as well as with many banking organizations that are considering doing so (so-called "opt-in" organizations). The issues raised in this letter are informed by those discussions. We focus here on the central themes, leaving reactions to specific points and technical aspects of the proposal for comment by individual banking firms.

In summary, ABA makes the following points:

- The proposed rule, if implemented as written, would have several adverse consequences for banking organizations subject to it.
- The final rule must be harmonized with the international Framework to achieve the intended goals of the Basel exercise.
- A menu of risk-based capital rules should be available to suit the diversity of the U.S. banking industry, including making the Standardized Approaches in the Framework an option for all U.S. banking organizations.
- The Agencies should proceed (taking due account of the recommendations described below) with finalization of the Basel II rules and allow banking firms to commence parallel runs to avoid further growth of development expenses.
- Banks should be permitted to qualify for and adopt the Advanced Approaches for some portfolios or business lines while continuing to use less sophisticated approaches for others.

These points are discussed in greater detail below.

The proposed Basel II Rule would have adverse consequences for adopting institutions.

From the perspective of both the core and potential opt-in institutions, the Agencies have made significant changes in the proposal that deviate from the Framework. The changes impose a cumulative conservatism that would prevent U.S. banking organizations from realizing the benefits that were anticipated at the inauguration of the international Basel II exercise, benefits which foreign competitors will enjoy.

Bankers assess risks, and allocate capital to protect against those risks, on a daily basis. This is done for reasons apart from regulatory capital requirements. The large and internationally active banking firms that would be subject to the rule have used internal models for years and have demonstrated the reliability of these models throughout all phases of the credit cycle under the scrutiny of resident regulatory supervisors. However, the layers of restrictions and prescriptions in the proposed rule would undermine the development of such state-of-the-art, institution-specific risk measurement programs. Moreover, potential opt-in institutions would be confronted with an even higher threshold for adopting the Basel II risk-management practices – at a very low reward. This would distinctly discourage the adoption of the Advanced Approaches by mid-tier institutions.

In devising any capital rule, the Agencies need to remember that the rule imposes a minimum capital requirement under Pillar I. If additional capital is warranted, then supervisors can require it under Pillar II guidelines for institutions using a Basel II approach. Moreover, the financial markets may demand it under the Pillar III enhanced market discipline, impelled by increased disclosures. Thus, the excessive, added elements of the proposal are unwarranted.

Not only is the proposed approach more costly in terms of capital for U.S. institutions, but also the actual costs of implementation are likely to be much higher. A U.S. Basel II institution would either have to use the limited regulatory model for risk management or go to the considerable expense to develop a parallel and superior system for actual risk management. Multinational banking firms would have to run multiple systems for the different rules in the U.S. and elsewhere. We would also note that the enormous development costs for banks continue to grow with each deviation from the Framework, as well as with each delay in finalizing the U.S. rules and allowing institutions to put the systems into operation.

Just as serious, the proposed rule would require banks to comply with different capital regimes in different countries. This puts domestic banking operations at a cost disadvantage. It also complicates business planning and operations for internationally active U.S. banks that have to evaluate capital costs when considering where to book assets and liabilities. The Agencies have proposed approaches that are more restrictive and prescriptive as compared to the Framework or the schemes being implemented in other countries. The result would be higher minimum regulatory capital for U.S. banking operations than for foreign banking operations presenting similar risks, along with additional limitations that slow implementation. In general, foreign banks would gain a competitive advantage over U.S. banks in lending and investment activities, threatening the prominence of U.S. banking institutions among the world's largest and most profitable, and U.S. banks would have increased incentive to conduct business through offshore entities.

The Agencies should harmonize the U.S. rule with the international Basel II Framework.

ABA remains committed to the adoption of the Advanced Approaches. Accordingly, we recommend that the Agencies adopt rules that more closely adhere to the Framework that was agreed to after years of international negotiations of the Basel Committee on Banking Supervision. Prudent changes to the proposal could make the Advanced Approaches a workable, effective means for determining how much capital is appropriate for adopting institutions.

In addition to the specific points that will be submitted by banks, we recommend that the final rule be changed from the proposal to:

- conform the length of the transition period to those used by other nations;
- use the same transition thresholds that are being used by other countries;
- eliminate the threat of fundamental changes in Basel II implementation, if application of the standards leads to reductions in required risk-based capital during the transition period;
- reconsider the concept of the leverage ratio and the risks it is intended to cover;
- remove from the definition of "default" any exposure that has credit-related losses of five percent or more in connection with the sale of the exposure or the transfer of the exposure to the held-for-sale, available-for-sale, trading account, or other reporting category and otherwise conform the U.S. definition of "default" to the definition used in the Framework;
- eliminate the requirement for multiple determinations of loss given default;
- recognize the lower risk of lending to small and medium-sized businesses;

- eliminate the restrictive treatment for equity investments in a financial company that has any material liabilities; and
- deconsolidate bank holding company insurance subsidiaries for risk-based capital.

These recommendations are explained below.

Lengthy Implementation Period. The proposed implementation period is longer than that in other nations implementing Basel II. The proposal provides for a phase-in over three years. Based on its assessment of the institution's ongoing compliance with the qualification requirements, the primary federal supervisor would determine when the institution is ready to move from one transitional floor to the next, and ultimately to move to stand-alone use of the Advanced Approaches. This proposal appears to extend the schedule at least one and possibly two years beyond the schedule for Canadian, European and Japanese banking organizations – an additional competitive disadvantage for U.S. banking organizations. In addition, U.S. banks will have the cost of maintaining the calculation of an equivalent Basel I minimum capital requirement for longer. The U.S. implementation period should be shortened to conform to other Basel II nations.

High Transition Thresholds. The proposal would limit reductions in an institution's risk-based capital requirement in each year of the three-year transition period to no more than five percent of the capital requirement under the current standard. These limits are more restrictive than those of other countries. The proposal's floors should be brought into conformity with other nations.

Ten Percent Tripwire. The proposal provides that a ten percent or greater reduction in total risk-based capital required for all Basel II banking organizations would constitute "a material reduction warranting modifications to the supervisory risk functions or other aspects of this framework."[2] None of the other nations on Basel II has a similar tripwire. The Agencies should eliminate this competitive inequity. It defeats the avowed purpose of making Basel II more risk sensitive and introduces considerable uncertainty into a process that is requiring each bank that expects to operate under Basel II to spend hundreds of millions of dollars.

Ten percent is an arbitrary trigger. It has no relationship to economic conditions. After all, any bank using the new rule may shift into lower risk assets with commensurately lower required capital under the new rule, and out of higher risk assets with higher required capital. Should there be a capital ***disincentive*** to that? In the end, users in aggregate may even be expected to reduce significantly their capital requirements because they have reduced significantly their risk profiles. Moreover, relatively large reductions in required capital for just a few very large institutions could bring the aggregate reduction of the overall user group to ten percent or more. In this case, it would be unfair to trigger this capital reduction collar and penalize all users.

Leverage Ratio Standard. The proposal provides that the leverage standard will continue to apply to all U.S. banks. For almost every U.S. institution subject to Basel II, the leverage ratio is now and will likely continue to be the binding capital requirement. This will render the risk-based capital and Tier 1 capital standards as expensive but meaningless exercises for these institutions.

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[2] Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision, "Risk-Based Capital Standards: Advanced Capital Adequacy Framework;" 71 Federal Register 55830; September 25, 2006, page 55839. (See www.fdic.gov/regulations/laws/federal/2006/06proposeAC73.pdf.)

We understand that the regulators are concerned about the uncertainties inherent in the adoption of a new risk-based capital rule. We understand that the leverage ratio can provide protection during the transition period. However, as the Agencies and the banking industry gain more experience with Basel II, we believe it would be appropriate to revisit the need for this standard. The point of the leverage ratio is to capture risks not considered under the risk-based standard. With inclusion of interest rate and concentration risks in the capital standards in 1995, and of operational risk along with Basel II, the continued role of the leverage standard is no longer clear. For this reason, all other nations participating in the Basel II process except Canada see no need for a leverage requirement. Comprehensive revision of the risk-based capital standards, now under consideration, will therefore provide an opportunity to reconsider what risks the leverage ratio is left to cover, and whether it should be revised or eliminated.

<u>Treatment of Credit-Related Losses in the Definition of Default</u>. The proposal provides that a credit-related loss of five percent or more on the sale of an asset would be treated as a default. This provision should be deleted from the U.S. rule. As a result of the application of this provision, all other credits to the same borrower would have to be treated as in default. This deviates from the Framework and from the advance proposal,[3] which was based on U.S. regulations and common practice. By prescribing this regulatory definition of default, existing models would have to be changed, at considerable extra cost to users. Equally important, an unintended consequence of this provision would be to discourage certain risk mitigation sale strategies. For example, institutions could be inhibited from diversifying out of positions (1) that were originally taken at below-market rates or (2) when there is a change in market perceptions of a firm.

<u>Other Changes to the Definition of Default</u>. The proposed definition of default is more prescriptive than that of the Framework and would result in a lack of comparability with probability of default ("PD") and loss given default ("LGD") calculations in other regulatory jurisdictions. Institutions with overseas subsidiaries and foreign institutions with U.S. subsidiaries would need default data and internal risk management aligned against two different definitions. The cost and operational complexity of running dual systems would be significant and do not seem justified by the benefit of this more prescriptive approach.

<u>Multiple LGD Calculations</u>. Under the proposal, banks would have to compute both default-weighted average expected LGD and downturn (stressed) LGD. However, a downturn LGD is incompatible with the proposed capital formula. The formula is intended to calculate potential aggregate losses at a high confidence level (99.9 percent), which is already a stressed environment. If the formula expects the parameters to reflect average values, then putting in downturn values for LGD compounds the conservatism of the calculation.

If examiners will not accept a bank's own estimates, then the bank would be required to use a supervisory formula. The formula reflects extreme losses even with the average value of LGD as an input, so it artificially increases LGD as the default-weighted average expected LGD decreases. Because of the infrequency of U.S. recessions, banks will find it very difficult to find enough downturn data to satisfy examiners. Thus, the result would be greatly increased capital requirements for U.S. institutions, making them less competitive for good quality assets. Additionally, U.S. institutions would have to

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[3] Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision, "Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord; Internal Ratings-Based Systems for Corporate Credit and Operational Risk Advanced Measurement Approaches for Regulatory Capital; Proposed Rule and Notice, 68 <u>Federal Register</u> 61063, August 4, 2003 (www.fdic.gov/regulations/laws/federal/03baselaccord.pdf).

maintain multiple LGD estimates, increasing their compliance burden. The rules should eliminate the requirement for multiple determinations of LGD.

If a requirement for multiple LGDs is retained in the final rule, then ABA recommends that the Agencies provide exceptions to the general rule that otherwise requires multiple LGDs across all credit exposures. One key exception should be loans with liquid collateral that is marked to market and can be liquidated if margin calls are not met. This type of lending arrangement has a built-in immunity to declines in collateral value, and should not be subject to this rule. There may be other categories with similar characteristics.

Small and Medium-Sized Business Lending. The Framework recognizes the lower risk of lending to smaller firms and has reflected this in a reduced capital requirement. However, the proposal ignores this lower risk. The consequence would be that U.S. institutions would be relatively discouraged by the proposed rules to lend to small and medium-sized firms, a result not justified by the risk – and bad economic policy as well. To match regulatory capital with actual risk, the U.S. rules should conform to the Framework.

Restrictive Equity Treatment. The proposal imposes a restrictive capital treatment for equity investments in a financial company that has material liabilities (such as bank loans). This treatment is not in the Framework, and no country implementing Basel II has applied a similar interpretation. The result would be a competitive disadvantage for U.S. institutions seeking to expand business opportunities through equity investments. The U.S. rules should eliminate this restrictive treatment for equity investments in a financial company with material liabilities.

Deconsolidation of Insurance Subsidiaries. Under the Framework, as well as the 2003 U.S. advance proposal on Basel II, a bank holding company's insurance subsidiary would be deconsolidated for capital purposes. Under the proposal, in the capital requirement of the consolidated holding company with consolidated insurance underwriting subsidiaries that are functionally regulated, the assets and liabilities of the subsidiary would be consolidated for purposes of determining the holding company's risk-weighted assets. However, the holding company would have to deduct from consolidated capital an amount equal to the insurance underwriting subsidiary's minimum regulatory capital requirement. This unbalanced treatment needs to be aligned with the Framework.

A menu of risk-based capital rules should be available to suit the diversity of the U.S. banking industry.

Appropriate changes to the proposed standard could make the Advanced Approaches workable and effective for determining regulatory risk-based capital for adopting institutions. If the problems highlighted in this letter and those from bankers can be resolved, ABA supports adoption of the Advanced Approaches as one option for banks.

It is possible that the Advanced Approaches could result in lower capital charges for some banking firms. This could enable these institutions to make the same loans as other banks but at an appreciably lower capital assessment. This in turn could make it worthwhile for some institutions to acquire others in order to unlock "excess capital." To guard against creating regulatory-driven competitive imbalances as a result of this capital exercise, the Agencies need to provide flexibility for banks of all sizes to apply capital standards that best fit their businesses. It is imperative that the Agencies not create winners and losers from a bad match in capital standards.

We believe that the Agencies share this view, and we applaud them for proposing reforms for the current rules, in effect creating a menu of capital standards to accommodate the wide variety and diversity of banking firms in the United States.[4] ABA will comment on these proposed "Basel IA" rules in a separate letter. Much of the concerns over capital standards driving bank competition within this country will be addressed if the Agencies install a robust menu program for capital, beginning with a Basel IA system that takes into consideration the recommendations submitted by ABA and our member banks. Moreover, an important element of that proposal is to allow banks to remain on the current "Basel I" system if they so choose. In addition, we believe that the risk of badly fitting capital standards will remain for a significant number of institutions unless the menu for U.S. banks includes the option of adopting the Framework's Standardized Approaches.

A number of large regional and nationwide banks compete directly for much of the same customer base with the banking firms that implement the Advanced Approaches. Although they are all moving forward with their risk metrics, many institutions cannot justify the enormous cost of developing, implementing and maintaining the Advanced Approaches. But with so much overlap in customers, incongruous capital requirements can create competitive inequities in pricing loans and other financial products. Judging from the proposal, Basel IA is not going to be sufficiently risk sensitive for the needs of many of these banks. Another level of rigor is needed in the capital standards.

The Standardized Approaches in the Framework could suit the needs of many institutions. Since the Framework provides alternatives to the Advanced Approaches, and since those alternatives will be available to banks chartered in every other country adopting the Basel II program, there is no sound reason for the U.S. to deny our banks this option. The terms and conditions of the Standardized Approaches are set forth in great detail in the Framework that the Agencies approved in June 2004. With so much work already done on these approaches, their inclusion in a menu of capital options for American institutions should not require extensive additional work. The institutions that currently seem most interested in using the Standardized Approaches agree that major modification of the Standardized Approaches as set out in the Framework does not appear justified. We therefore recommend adoption of the internationally agreed upon Framework's Standardized Approaches.

A number of core banks also prefer to have the Standardized Approaches as an option. These banks see the cumulative conservatism discussed above as creating a disconnect between the rules as proposed and the objective of greater risk sensitivity in capital allocation. Rather than incur the enormous expense of applying the Advanced Approaches, these institutions would prefer the middle ground of the Standardized Approaches, which offer greater risk sensitivity than the current capital rules but incur less expensive to implement than the Advanced Approaches. We strongly recommend that the Standardized Approaches – as agreed to as part of the Framework – be an option for core banks, as well as for other banks.

The Framework would attach an operational risk component to the risk-based capital requirement for credit risk. The Agencies have proposed not to include an operational risk component for the Basel I or Basel IA approaches, and ABA agrees with that decision. However, our conversations with the larger organizations that would consider the Standardized Approaches indicate that they can accept an operational risk component – provided that they are allowed to select from all of the Framework's

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[4] Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision, "Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications, 71 Federal Register 77446, Dec. 26, 2006 (www.fdic.gov/regulations/laws/federal/2006/06proposeac96.pdf).

choices for operational risk, including the Basic Indicator, Standardized, and Advanced Measurement Approaches.

- In sum, the U.S. needs a multi-tiered menu of options for risk-based capital standards in order to accommodate the structural diversity of the U.S. banking industry without creating competitive inequities, including:
- Basel I as the base standard;
- Basel IA with more risk-sensitive capital and additional documentation of risk mitigating factors;
- the Standardized Approaches in the Framework, which would be even more risk sensitive and would include all of the operational risk approaches from the Framework; and
- the Advanced Approaches – harmonized with the Framework.

The Agencies should finalize the Basel II rules and allow banking firms to commence parallel runs to avoid further growth of development expenses.

The largest U.S. banking institutions have worked closely with the Agencies throughout the Basel II development process. While much has been gained from the dialogue between bankers and regulators, this process has been long and expensive. The Agencies have more than once postponed the parallel runs and implementation of Basel II in the U.S., and the development costs for the banks continue to grow.

Meanwhile, most of the other nations that will use Basel II have already finalized their rules, at least for Pillar I. Canada and Japan have already commenced parallel runs. Therefore, multinational institutions are facing the prospect of having to deal with totally different capital systems in the U.S. and elsewhere.

It is time for the Agencies to finalize the rules and begin implementation of Basel II. Further delay will escalate costs and compound complications.
However, it is very important that the Basel IA and Standardized Approaches be finalized in this country over the same timeframe as the Advanced Approaches. The core institutions have been working on their Basel II systems for years. If the revised capital rules for the industry as a whole are applied after the Advanced Approaches, then the institutions that use the Advanced Approaches will be ready to gain whatever benefits are to be gained from these rules while the rules governing all others will be lagging behind. Many of these second-stage institutions could, as an unintended result of a regulatory timing issue, unfairly lose customers and business to their rivals. Therefore, the Agencies need to move forward expeditiously with the full set of capital rules that will apply for all sectors of the banking industry. This way the entire industry can be prepared to follow standards in a way that is competitively neutral.

The Agencies should allow phased implementation for the Advanced Approaches.

ABA notes that in our discussions of implementation with foreign bank trade associations[5] that the other nations agreeing to the Framework allow a phased-in implementation of the Advanced Approaches. ABA recommends that banks be permitted to qualify for and adopt the Advanced Approaches for some portfolios or business lines, as permitted by other countries, while continuing to use less sophisticated approaches for other portfolios. Of course, this makes much more sense when combined with the option of using the Standardized Approaches, which ABA is also recommending.

[5] ABA is a member of the International Banking Federation (IBFed). The IBFed membership includes the national banking associations of all of the nations that are core members of the Basel Committee on Banking Supervision.

Conclusion

ABA remains firmly in support of the Advanced Approaches for large, internationally active institutions. The Agencies need to harmonize the U.S. version with the Framework that they, along with the other members of the Basel Committee on Banking Supervision, all agreed with in June 2004. This will provide international consistency in capital standards, more closely tie regulatory capital to actual risk, avoid competitive inequities for our banks competing against foreign institutions, and reduce compliance burdens.

In order to minimize competitive concerns within the domestic banking industry, the Agencies need to adopt a menu approach to risk-based capital standards, which includes Basel I, Basel IA and the Standardized and Advanced Approaches from the Framework. It is important that risk and capital be appropriately linked for all banks regardless of their size and in such a way as to avoid creating competitive disparities. However, the efforts to improve the risk sensitivity of regulatory capital requirements should not result in disproportionate compliance burdens. Applying a select menu of reasonable capital standards for banks of all sizes is the best course of action.

Given the complexity of the proposal and the number of questions that we have addressed, we invite the staff of the Agencies to contact the undersigned if they have any questions about our comments.

Sincerely,

Paul Alan Smith

Paul A. Smith
Senior Counsel

Robert W. Strand

Robert W. Strand
Senior Economist