THE FINANCIAL SERVICES ROUNDTABLE

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November 3, 2003

Communications Division
Public Information Room, Mailstop 1-5
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219
Attention: Docket No. 03-14

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Attn: Docket No. 2003-27

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551
Docket No. R-1154

Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance
Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord

Dear Sirs or Madams:

The Financial Services Roundtable (the "Roundtable") represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic engine accounting directly for $18.3 trillion in managed assets, $678 billion in revenue, and 2.1 million jobs. The Roundtable appreciates the opportunity to comment to the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), and the Office of Thrift Supervision ("OTS") (collectively, "the agencies") on the advance notice of proposed rulemaking to implement the new Basel Capital Accord ("Basel II" or the "New Accord") in the United States.

Introduction

The Roundtable notes its tremendous respect for the diligence and stamina of the regulators who have worked on the New Accord. We appreciate the efforts of Board Vice Chairman Roger Ferguson, who has met with Roundtable member companies several times to listen to our concerns. Comptroller Hawke and FDIC Chairman Powell also have been very open to our ideas throughout the long process of developing the New Accord. We look forward to continuing this dialogue as the New Accord moves closer toward formal adoption and throughout the implementation period.

The Roundtable and its member companies have been active in the Basel II consultation process, submitting several comment letters to the Basel Committee on Banking Supervision and testifying before both the House Committee on Financial Services and the Senate Banking Committee. The Roundtable supports the goal of revising the existing capital adequacy requirements for internationally active banks. We agree with the overall objectives of the New Accord, which include creating a better alignment of regulatory capital to underlying economic risks, promoting better risk management, and fostering international consistency in regulatory standards.

The New Accord would replace the 1988 Basel Capital Accord, which is viewed as increasingly outdated. The impact of the New Accord on financial institutions, the financial marketplace, and evolving methods and practices of risk management will be far-reaching. Implementation of the New Accord poses significant challenges for banking institutions as well as regulators. There will be a bifurcated supervisory framework in the United States: one for the core banks and opt-in institutions and another for all others, which will continue to use current risk-based capital rules for measuring capital. The Roundtable offers the following comments to the agencies in an effort to relate the concerns of the industry and to assist with the difficult task of implementing the New Accord.

- The New Accord is prescriptive, unnecessarily complex and costly to implement
- There will likely be conflicts between home and host country supervisors
- There is a potential competitive disadvantage among U.S. banks, foreign banks and U.S. non-banks
- The cumulative effect of conservative assumptions made throughout the New Accord should be recognized
- Some have questioned whether the capital requirements of the New Accord may adversely affect lending during an economic downturn (pro-cyclicality)
- The operational risk capital charge remains the subject of debate
- The Pillar III disclosure rules are burdensome
- The capital requirements for various types of assets may be a disincentive for certain markets
- The treatment of expected losses should be modified

<u>The New Accord is Prescriptive, Unnecessarily Complex and Costly to Implement</u>

1. <u>Prescriptive Rules</u> - The New Accord shifts the regulatory emphasis toward a highly complex, formula-based system, and will diminish the important role that is currently played by human judgment. These international rules could bring a more formulaic, inflexible style of regulation to the United States, which currently enjoys a

reasonable balance between black-letter rules and supervisory consultations. Most of this prescriptiveness is to be found in Pillar I, but as described below the detailed prescriptive requirements for disclosures under Pillar III are also problematic. Implementation of these rules will be costly, but not necessarily cost effective. It is important that the detailed requirements and implementation of the New Accord not interfere with the future evolution and refinement of risk models among the most sophisticated banks.

The Roundtable recommends that the focus be on simple basic requirements, largely around the key input parameters and exposure calculations, and that the agencies publish best practices that provide guidance to banks and supervisors rather than a rigid rulebook. We recommend that, in applying the New Accord and reviewing the eligibility of systems under the IRB and AMA approaches, the agencies seek to avoid dictating the form and structure of a bank's risk management system, and that the agencies put more weight on Pillar II. Pillar II allows supervisors to adjust an individual bank's capital requirements on a case-by-case basis to address risks not adequately reflected in the Pillar I quantitative formulas.

2. Cost - The monetary cost of complying with the New Accord will be significant. Implementation, especially the advanced methods for determining credit risk and operational risk charges using internal models, will require banks as well as regulators to devote substantial resources to new systems and personnel training. One of our member companies has estimated that the initial costs will be in the tens of millions of dollars to implement the system, plus multi-million dollar ongoing costs. Other estimates vary, but all agree that establishing and maintaining the new systems will be a major undertaking. Some of these costs will be passed on to consumers, and in some cases these costs could force banks to discontinue certain activities, leaving these markets to unregulated entities.

3. Adaptability - The proposed Basel rules are based on the financial markets as they are today. However, the rules are so complex and heavily negotiated that they may be difficult to update over time. The New Accord requires banks to use specific processes for internal management in many areas, regardless of whether they are relevant for business practices. If bank management is required to compute and manage by the New Accord's rules, further improvements in internal practice might be seen as both costly and irrelevant. The New Accord should not be permitted to slow the progress and introduction of better private sector risk management techniques. Adopting a more "principles-based" approach, subject to some reasonable benchmarks and guidelines for consistency, has important natural advantages compared to the "black-letter" style rules currently proposed under Pillar I. It would encourage banks and regulators to work together over time to improve risk management practices, rather than forcing compliance with a dated rulebook. A principles-based approach would permit steady, evolutionary improvement and therefore should be more durable and relevant than Pillar I rules that are designed with only today's markets in mind.

There Will Likely be Conflicts between Home and Host Country Supervisors

The complexity of the new rules poses particular challenges for international banks that are regulated by supervisors in a number of countries. The Roundtable endorses comments made by Board Vice Chairman Ferguson in June 2003 indicating that the U.S. regulators expect to accept the New Accord approaches and calculations followed by a bank's home country supervisors when evaluating an international bank with U.S. branches, as well as for purposes of eligibility of financial holding company status.

The Roundtable supports the principles outlined in the Basel Committee's Publication No. 100 titled, "High-level Principles for the Cross-Border Implementation of the New Accord," especially the recognition of primacy of home country supervisors on capital issues. We also endorse the Committee's recommendation that home and host country supervisors organize practical plans of cooperation prior to the implementation date, with a view to improving supervisory efficiency and reducing the implementation burden on banks.

The Roundtable hopes these efforts will develop lasting mechanisms to resolve home/host country conflicts in a timely and predictable manner, both during and after the implementation period. Roundtable member companies are concerned about the potential for inconsistent regulatory supervision for internationally active banks, and by the high compliance costs that may result from the need for parallel, but different, capital calculations in multiple regulatory jurisdictions. The Roundtable recommends that the U.S. agencies take a proactive, leadership role in working with their foreign counterparts in an effort to address these concerns.

There is a Potential Competitive Disadvantage among U.S. Banks, Foreign Banks and U.S. Non-Banks

Regulators should work closely to ensure that United States banks will not be competitively disadvantaged *vis a vis* foreign banks and U.S. non-banks. In the U.S., non-bank competitors such as investment banks, finance companies and insurance companies make up a large part of the financial system. The Basel rules do not apply to them. If the costs of the New Accord are high, banks will earn a lower return on capital, will grow more slowly, and will lose market share. There may even be some incentives to abandon certain businesses or to de-bank altogether.

The OCC and others have questioned whether the New Accord will be enforced less vigorously on banks in some other countries. If so, this could create competitive inequality between U.S. and foreign banks. We recommend that U.S. regulators keep this is mind when implementing the New Accord and that they continue to work with their foreign counterparts in achieving the appropriate balance in these areas.

The Cumulative Effect of Conservative Assumptions Made throughout the New Accord should be Recognized

Many of the requirements and standards in the New Accord are unduly conservative. Examples include: floors on capital minimums; the forced use of conservative loss given default ("LGD") and exposure at default ("EAD") parameters in several portfolios; 99.9% confidence interval requirements; stress test assumptions; the 60 basis point floor on asset value correlations for retail exposures; the 20% limit on insurance in offsetting operational risk capital charges; the limited recognition of future margin income; the lack of recognition of double default effects in credit risk mitigation; the significantly higher capital charges required for equity investments; and the absence of any quantitative recognition of the risk-reducing benefits of diversification in portfolios and business lines. Taken individually, each such assumption or decision is debatable. Taken together, the cumulative effect of these separate decisions is a much more conservative, prescriptive and burdensome Accord. The agencies are urged to consider industry concerns over the excessively conservative tilt to the proposed New Accord when reviewing implementation issues and in calibrating the final Accord. In addition, Pillar II should expressly state that supervisory reviews will permit discussions between banking organizations and their regulators in identifying situations where some elements or assumptions of Pillar I formulas are unrealistic and adjusting or reducing capital cushions accordingly.

Some Have Questioned Whether the Capital Requirements of the New Accord May Adversely Affect Lending During an Economic Downturn (Pro-Cyclicality)

The new rules will change how banks calculate and manage their capital and the amount of business they choose to do. If Basel II banks all respond to economic changes and risk-based capital requirements in a similar manner – as they may tend to do under a common regulatory regime – this could significantly increase or decrease liquidity in the credit markets and ultimately affect the real economy.

Roundtable member companies have different views on whether the New Accord would significantly increase pro-cyclicality and ultimately affect the economy. Some believe that the new rules will affect banks' calculation and management of capital during economic downturns, thereby exacerbating liquidity concerns. Other member companies believe that more risk-sensitive capital requirements will not lead to procyclical lending, if prudently managed.

The current Pillar II proposals require each bank to develop a credit risk "stress test" that is directly linked to possible additional capital requirements. The exact parameters for this test remain unclear but the language suggests it amounts to an extra layer of buffer capital so that banks will not need to dig into their core capital in difficult times. The Roundtable suggests that either the New Accord or the U.S. implementation rules include

an explicit acknowledgment that capital levels may fluctuate, and that Pillar II reviews and stress tests should not become one-way ratchets that only increase regulatory capital requirements. If a stress test is to work properly and reduce pro-cyclicality, then banks should be permitted to live within their plans during difficult times, and regulators should resist the temptation to continue to require the same untouched capital cushion.

The Operational Risk Capital Charge Remains the Subject of Debate

In addition to reforming capital charges for credit risk, the New Accord establishes a new capital charge for operational risk – the risk of breakdowns in systems and people. It is important to distinguish between the concepts of managing operational risk and imposing a separate, quantitative capital requirement for it. The operational risk capital charge proposed by the Basel Committee has produced much debate among financial institutions. The Roundtable's member companies agree that evaluating and controlling operational risk is important and should be required as a supervisory and business matter. Roundtable members do not agree on whether or how operational risk should be reflected in regulatory capital calculations. Many companies believe operational risk can best be addressed through case-by-case supervisory reviews under Pillar II; others favor a quantitative and a publicly disclosed capital charge under Pillar I.

The Pillar III Disclosure Rules are Burdensome

Pillar III seeks to enhance market discipline through increased public disclosure requirements. The New Accord requires that a bank make extensive additional disclosures about its risk profile and risk management process. The Roundtable firmly supports transparency and disclosure as worthwhile goals; however, many of the detailed proposals in the Pillar III market disclosures section are burdensome and technical and would impose a significant competitive disadvantage on banks compared to institutions not subject to the Accord.

While the latest draft reduced somewhat the list of disclosures compared to earlier versions, more streamlining is needed. The Pillar III proposals require voluminous disclosures that are highly technical in nature and which we believe would be of little benefit to the reader. Indeed, few people are able to digest all of the information that is already presented on risks. Under the New Accord, relevant information could be lost in a deeper, more technical mass of data. The additional requirements proposed under Pillar III are more likely to confuse than illuminate.

Of particular concern are the numerous required disclosures that relate directly to the capital calculations performed within Pillar I. Instead of disclosing measures of risk used in internal risk management systems, these disclosures mandate an explicit regulatory capital view of risk. In the most complex areas, such as asset securitization, these disclosures will surely be mystifying to all but the most expert audiences.

Moreover, there is a need to ensure that risk management practice is able to mature beyond the concepts now embedded in the New Accord proposals. Just as the market has moved beyond the current accord, there inevitably will come a time when some Pillar I calculations are no longer regarded as good measures of risk for all products. In that case, it must be possible for banks to alter disclosures to represent emerging best practices without waiting for formal changes in the New Accord. Under Pillar III as currently proposed, banks will likely find themselves constrained to disclosing risks under a system that is no longer wholly relevant.

The Roundtable recommends replacing Pillar III's list of specific items with more flexible disclosure principles. Other concerns about Pillar III that we believe need further consideration include preserving the confidentiality of sensitive and proprietary information; the potential for increased risk of litigation or liability in mandating disclosure of information that is of doubtful relevance, misunderstood or, in the case of operational risk, focused on hypothetically significant but unpredictable and unlikely events; and the effect of Sarbanes-Oxley Act officer certifications and other provisions. Roundtable members are also concerned about the added burdens of frequent Pillar III disclosures. We believe that most of the new required items should be disclosed only annually, not quarterly.

<u>The Capital Requirements for Various Types of Assets May be a Disincentive for Certain Markets</u>

The Roundtable believes that the capital requirements proposed for various types of assets, particularly securitized debt and commercial real estate loans, are sufficiently high as to have the unintended and unnecessary consequence of being a disincentive for those markets. The Roundtable believes that the New Accord should be constructed with the intent of having a neutral effect on these and other financial activities. The Roundtable offers the following comments on the effect of the New Accord in various lending areas.

1. <u>Asset Securitization</u>

Asset securitizations are a cornerstone of how the U.S. markets finance residential mortgages, consumer credit card balances, automobile loans and other receivables. The securitization rules in the New Accord are potentially very burdensome, and often difficult to interpret. The result is that only a few experts in each area are likely to understand these specialized rules.

The various approaches to securitizations under the New Accord have raised some concern in the financial services industry. Roundtable member companies do not believe that the Standardized Approach, Ratings Based Approach ("RBA"), or the Supervisory Formula Approach ("SFA") will provide a viable method for measuring required capital for liquidity facilities.

In many cases, under the New Accord, securitization will tend to increase the capital charge assigned to the same pool of assets. For example, the originating bank would be charged with capital on the full risk of the asset pool if it retained an exposure at least equal to K_{IRB}. Investing banks that purchased securities in the securitization also will be charged significant capital, meaning that the total capital required of the banking system will be higher than if the assets had not been securitized.

This is a very important issue for the U.S. markets in particular, as compared to markets in other countries, which are much less reliant on securitization technology. The proposed approach will raise costs for funding U.S. consumer loans and other asset classes where securitization techniques are important. The Roundtable is concerned that the additional costs and burden resulting from the application of these rules will negatively impact the attractiveness of this type of financing, resulting in higher cost of financing in the capital markets and negative consequences for the U.S. economy as a whole. The Roundtable welcomes the Basel Committee's October 11th announcement that the treatment of securitization will be revised and the Supervisory Approach will be replaced with a less complex approach. We urge the agencies to continue to take a leading role in the discussion on securitization issues because of their importance to the U.S markets.

2. <u>Commercial Real Estate</u>

Commercial Real Estate ("CRE") lending constitutes an important component of the loan portfolios for many banks. The New Accord's requirements may have a significant impact on these institutions' competitive positions compared to non-bank lenders. Roundtable member companies believe that the credit risk charges for "high volatility" CRE are too high as compared with other corporate exposures.

There is no industry data that indicates that acquisition, development, and construction ("ADC") loans are higher in volatility or pose any greater risk than investment real estate loans or corporate and industrial ("C&I") exposures. Many ADC loans are supported by collateral and guarantees, which are an effective risk transfer mechanism. Also, many construction loans have duration of less than three years. This mitigates the likelihood of financial deterioration for the obligor or guarantor and reduces the need for excess capital.

3. <u>Residential Mortgage Lending</u>

There are still some outstanding issues in determining the minimal regulatory capital charges for single-family residential mortgages. The 15% asset value correlation ("AVC") assumption assigned to residential mortgage loans should be reviewed.

Industry surveys suggest loans with initial loan to value ("LTV") ratio above 80% perform very differently than lower LTV loans. To avoid excessive credit risk charges,

the correlation factor should be lower for low LTV loans and be higher as one moves up the LTV scale. It may be appropriate for low LTV loans to have an AVC of 10% and high LTV loans to have an AVC of 20% or higher.

The 10 percent floor on LGD figures for residential mortgages should be eliminated or reduced since LGD is well below 10 percent for many banks' mortgage portfolios. The Roundtable is also concerned about whether the New Accord will recognize private mortgage insurance appropriately, and the treatment of different types of residential mortgage loans, including first mortgages, home equity loans and home equity lines of credit. Many believe that these mortgage loan categories should be separated in risk weight calculations.

4. Retail Lending

The Roundtable is pleased that the Basel Committee is revisiting the treatment of credit card commitments and related issues. We agree that the New Accord's approach to credit card portfolios needs improvement.

Retail lenders have forecasted capital requirements in this area that contradict the Committee's goal of capital neutrality. The Committee's Third Quantitative Impact Study ("QIS 3") predicts that regulatory capital required for Qualifying Revolving Exposure ("QRE") portfolios will increase by 16 percent beyond the regulatory capital required by the current risk-based capital rules, while regulatory capital required for mortgage and other retail portfolios could decrease substantially, by 56 percent and 25 percent respectively.

Despite significant work by the U.S. banking agencies and retail lenders, the Roundtable believes that the capital curves for QREs remain inappropriately calibrated. Based on the data accumulated thus far, unsecured retail lenders could be severely damaged by the New Accord, and the economies that depend on consumer lending could be significantly damaged as a result. In some circumstances, the additional capital required to operate these business lines could be the marginal cost that drives certain consumer lenders out of business. The Roundtable is concerned that the New Accord's current assumptions and mathematical models for QRE portfolios would produce the associated credit risk and substantially harm both the competitive position of credit card lenders and their ability to continue certain lines of business. Specifically, the QRE curve could require retail lenders to hold regulatory capital against lower-risk assets that do not properly reflect the credit risk presented by those assets. Banks would respond to that incentive by holding excessive capital for low-risk loans, potentially leading lenders to prefer to hold riskier assets in their portfolios.

The Roundtable is particularly concerned about the proposed approach to undrawn lines of credit for on- and off-balance sheet credit-card assets, which we believe substantially drives the capital impacts projected in QIS 3. The New Accord would take the position

that financial institutions must consider the likelihood of additional drawings on the unused portion of a credit card line when the bank determines its loss estimates. Under the IRB approaches (but, interestingly, not under the Standardized Approach), the bank must incorporate those risk assessments into the bank's calculation of EAD or LGD. We believe that this requirement could lead to a significant and unwarranted increase in the amount of capital that banks must hold against credit card accounts. As such, we strongly oppose this provision as we believe that it does not accurately reflect the true risk exposure faced by institutions engaged in this type of consumer lending.

Cancelable commitments do not require regulatory capital to be held against them for several reasons. Lenders will only permit future draws when appropriate capital funding is available, so up-front capitalization is unnecessary. As draws are booked, the lender increases capital in an amount sufficient to preserve the correct capital ratio. If at any point additional capital becomes unavailable, the lender immediately withdraws open lines. Future draws on open-to-buy are contingent on adequate future capital access. As such, there is no need to set aside capital in anticipation of future exposure. With cancelable commitments, capital at default will always be adequate for exposure at default if capital is simply accumulated as draws are booked.[1]

The Treatment of Expected Losses Should be Modified

Expected losses ("EL") are already taken into account by banks in pricing loans and other products and in determining appropriate levels for loan loss reserves. The current draft of the New Accord provides only partial recognition for loan loss reserves and the loss absorption capacity of predictable future revenues. For U.S. institutions in particular, it is not clear that the offsets for loss reserves would be fully available under current accounting practices. The Roundtable therefore welcomes the agencies' recent agreement to reconsider the treatment of EL and the inclusion of reserves in capital. Our members are currently reviewing the Basel Committee's October 11 proposal on EL, and we look forward to further details and discussions. Recalibration of the Pillar I formulas resulting from excluding EL and future margin income should be approached with care.

It is not clear if the October 11 proposal to adjust regulatory capital to reflect excesses or shortfalls in loan loss reserves compared to EL under the IRB approach implies a change in the definition of regulatory capital for all purposes. If so, and the result is a different definition of capital for Basel II banks and non-Basel II banks, the broader implications

[1] The New Accord already recognizes that cancelability is a critical determinant of capital needs. For example, the New Accord suggests that the Credit Conversion Factor for securitized uncommitted retail lines should range from 0% to 40%, depending upon excess spread, while the Credit Conversion Factor for committed retail lines is always 90%, regardless of spread. This distinction presumably acknowledges the more manageable exposure of cancelable lines, a feature that is also relevant for the calculation of on-balance sheet capitalization needs. Furthermore, the New Accord also suggests that the Credit Conversion Factor for certain uncommitted corporate facilities is 0%, versus 75% for committed facilities. We believe this logic should be extended to uncommitted retail facilities, particularly QRE's.

of this for comparing institutions, competitive equality and cross-references to total or Tier 1 capital in other contexts (e.g., prompt corrective action, leverage ratios, lending and investment limits, etc.) should be considered carefully.

Conclusion

We appreciate your consideration of the Roundtable's views on these important issues. The Basel Committee and the agencies have invested substantial resources into developing the New Accord and preparing for its implementation. However, more remains to be done. The timetable for implementation is challenging, particularly since the New Accord requires a minimum of three years of data for the advanced calculations. The Roundtable supports the Basel Committee's recent decision to postpone finalization of the New Accord until mid-2004. The Accord should benefit from further review of the important issues and industry concerns that remain to be resolved. In the pressure to finalize and implement the New Accord, we hope that enough time will be provided for everyone – banks and supervisors alike – to think about the implications of the New Accord, and to develop appropriate implementation rules. Furthermore, the Roundtable recommends that enough phase-in time be provided so that when the New Accord is implemented, there will be no issues that will negatively affect the financial services industry or the U.S. economy in general.

If you have any further questions or comments on this matter, please do not hesitate to contact me or John Beccia at (202) 289-4322.

Sincerely,

Richard M. Whiting

Richard M. Whiting
Executive Director and General Counsel