Sovereign Bank

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Sovereign Bank
1130 Berkshire Boulevard
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November 3, 2003

VIA FACSIMILE

Office of the Comptroller of the Currency
250 E Street, SW.
Public Information Room, MS 1-5
Attention: Docket # 03-14
Washington, DC 20219

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Attention: Docket # R-1154
Washington, DC 20551

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW.
Attention Comments
Washington, DC 20429

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

Re: No. 2003-27 - Advanced Notice of Proposed Rulemaking - New Basel Capital Accord
No. 2003-28 - Draft Supervisory Guidance - New Basel Capital Accord
CEO Memorandum # 177 – Basel Capital Accord

Dear Sir or Madam:

Sovereign Bank is pleased to submit this letter presenting our comments related to the New Basel Capital Accord (Basel II). Listed below are our comments on the Advanced Notice of Proposed Rulemaking (ANPR) and the Draft Supervisory Guidance, which were published in the Federal Register on August 4, 2003. Additionally, we have provided comments on the five questions posed by the Office of Thrift Supervision (OTS) in the CEO letter # 177 published on July 11, 2003.

Sovereign Bank is one of the 25 largest banking organizations in the United States, with assets of more than $41 billion at September 30, 2003. Sovereign has over 530 community banking offices, and more than 8,000 team members in Connecticut, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, and Rhode Island.

Our responses to these publications are detailed below in three parts:

- Comments on the Advanced Notice of Proposed Rulemaking
- Comments on the Draft Supervisory Guidance
- Comments on the OTS CEO Memorandum #177

Our comments for each of these documents are preliminary in nature, and do not yet reflect our final positions as we are still in the process of assessing the impact of Basel II on Sovereign Bank.

November 3, 2003

Advanced Notice of Proposed Rulemaking (ANPR) (No. 2003-27)

Comments on the Advanced Approaches

We believe that the implementation of Basel II in the United States will be a significant undertaking for financial institutions as well as the regulatory agencies (the Agencies). We support the Agencies' efforts in proposing the Basel II rules, and appreciate the opportunity to comment. Additionally, we believe that the US implementation proposed in the ANPR and Draft Supervisory guidance is well conceived and thorough. However, we believe, as discussed further below, the requirements for Core and Opt-In banks are too restrictive.

- Mandatory Application of Advanced Internal Ratings Based (A-IRB) Approach – Generally, we agree with the Agencies' emphasis on the A-IRB approach as the most thorough methodology for calculating a capital charge for credit risk. The ANPR indicates that the A-IRB should be implemented at the same time across all material portfolios, business lines, and geographic regions. The proposed rules also indicate that the Agencies will allow, with supervisory approval, exemptions from the A-IRB for exposures in non-significant business units and asset classes that are immaterial in terms of size and perceived risk. However, it appears based on the commentary in the ANPR, that the Agencies view deviations from the advanced approach will be the exception rather than the rule. *We think the expectation that institutions can apply the A-IRB to all material portfolios is too restrictive.*

  Most banking organizations hold certain portfolios of seasoned loans, which do not have sufficient data to apply the A-IRB. While these portfolios have sufficient data to manage them under current systems and procedures, they lack the detailed information necessary to apply the enhanced risk management techniques necessary for the A-IRB. These portfolios are commonly held by US banking organizations and may have maturities that extend well beyond the proposed implementation date of January 2007.

  Another impediment to applying the A-IRB approach uniformly will be non-compliant information systems. There are many loan application systems which may not be Basel II compliant by the January 2007 implementation. Likewise, loan servicers will also need to be Basel II compliant. The servicers will have to provide the supporting information to calculate capital under the new rules. Accordingly, banking organizations which adopt Basel II will have to convert to information systems or servicers which are Basel II compliant, or exclude those portfolios housed on the non-compliant systems or servicers from the application of the A-IRB approach.

  Therefore, we strongly suggest that the Agencies consider additional flexibility in applying the A-IRB. The ANPR suggests that any exemptions from the A-IRB would revert back to the appropriate risk weight category under the old capital rules, and thus lose any benefits obtained through the new risk sensitive calculation. However, we believe that the Agencies should consider other alternatives to the A-IRB. The international version of the accord allows for the use of the Foundation Internal Ratings Based Approach (F-IRB), and the Basic Indicator Approach (Basic). We suggest that the Agencies reconsider the F-IRB and the Basic approaches for use by US banking organizations. In doing so, banking organizations can choose the method that matches the level of sophistication of the information system or data availability for the various portfolios which they hold.

  Furthermore, we would acknowledge that allowing options other than the A-IRB model necessarily places additional responsibilities on banking organizations. It will be incumbent on management to demonstrate to its Board of Directors and the Agencies that deviations in application of the A-IRB approach are appropriate. This can only be accomplished by development of an integrated capital assessment process coupled with a comprehensive program to continually evaluate, monitor, and report risk data and loss information.

Comments on the Advanced Approaches – (continued)

The Agencies have invited comment on what thresholds might be appropriate for determining whether a portfolio, business line, or geographic region is material enough to require the A-IRB method. As described above, we believe that there will be significant portfolios, which will not allow for the use of the A-IRB method. Consequently, we have suggested more flexibility in applying the different methods for calculating credit risk and operational risk within Basel II.

In addition, we believe that a threshold for not applying any of the Basel II methods (and thus defaulting to the existing capital rules) is also warranted. Accordingly, we believe that for Sovereign Bank, the costs would exceed the benefits of applying any of the Basel II methods to portfolios less than $250 million. This number represents approximately 1% of our loans outstanding at September 30, 2003.

Comments on a Bifurcated Capital Framework

The proposed rules anticipate a bifurcated capital framework. We believe that this would be a significant change to the US banking system, and believe that it would be preferable to have a single risk based capital framework. Our detailed comments are as follows:

- Bifurcated Capital Framework – In the ANPR, the agencies invite comment on the pros and cons of a bifurcated capital framework. In concept, we believe that it would be preferable to have a single capital framework. (See also Comments on the CEO Memorandum – Question # 2 below.)

  One negative aspect of a bifurcated capital framework is that it will make comparability of capital levels and capital adequacy among institutions difficult. It has been suggested that Basel II institutions may have less required capital than other banks. However, advanced credit risk approaches and operational risks are not considered in the existing capital standards. Consequently, it is possible, that selected institutions which compute capital under the current system will be required to hold more capital than Basel II institutions which have a higher risk profile. This lack in comparability will provide a challenge to analysts and investors. It is probable that analysts will develop models, or other tools, in an attempt to create a capital comparability metric. In addition, some analysts have already indicated that they may disregard "capital savings" which may accrue from Basel II.

  The US banking system has flourished under the current single capital framework. The US implementation of the original Basel Accord in 1988, resulted in a single framework that has had extremely positive results. It has strengthened capital levels and fostered consistency and coordination, not only in the United States, but internationally as well. We believe that maintaining a single capital model in implementing Basel II will provide the most optimal structure for institutions, as well as their customers, investors and the banking industry as a whole.

  However, it is unreasonable to assume that all institutions in the US, in particular small community banks and thrifts, will be able to make the investment in people, processes, and systems necessary to implement the advanced approaches across all material portfolios currently mandated by Basel II. As such, we believe there is a need for an alternative to the proposed bifurcated capital framework. (See Alternative to a Bifurcated Capital framework below)

  Additionally, we would again emphasize the desire to have additional flexibility for the Opt-In banks in applying credit risk and operational risk methods other than the advanced approaches. More flexibility might increase the number of banking organizations that would opt-in to Basel II.

- Alternative to a Bifurcated Capital Framework – The Agencies have invited comment on whether changes should be made to the existing capital rules to enhance risk sensitivity. We believe that changing the existing capital rules might mitigate the potential disadvantage of a bifurcated capital framework.

Comments on a Bifurcated Capital Framework - continued

Changing the existing capital rules to be more risk sensitive might bring them more in line with the new capital rules under Basel II. This might be accomplished through giving additional capital relief for low risk assets. For example, by lowering the risk weighting for mortgages with low current LTV ratios (less than 70%) from the 50% category to the 20% category, the banking organization gets credit for the lower loss given default (LGD). Another example would be to allow a lower risk weighting for high quality auto loans with high FICO scores. The risk weighting for auto loans, which have a FICO score above a certain threshold, could be lowered from the 100% category to the 50% category.

Changes like these would allow the General Banks to also benefit from a capital framework that is more risk sensitive. If the Agencies pursue this avenue, we would suggest that any adjusted capital framework be submitted for public comment.

Modifying the existing capital rules should narrow the differences between Basel II institutions and the banks which remain subject to the 1988 Basel Accord. Since the new rules are based upon a very sophisticated calculation, simple conventions applied to the old rules will never duplicate the same capital charges as those calculated under the A-IRB. However, if there must be a bifurcated capital framework, any attempt to mitigate the differences between the two methods would be beneficial.

(For more on this topic, see **Comments on the OTS CEO Memorandum** (Question #2) below)

Comments regarding Opt-In Banks

- Which Banks Would "Opt-In" to Basel II – The Agencies have invited comment on whether institutions would be compelled for competitive reasons to opt-in to Basel II. Since Sovereign is considering "opting-in." we believe our comments in this area to be relevant. Based upon our analysis to date. there may be competitive advantages for most banking organizations which adopt Basel II.

  A potential significant benefit of adopting Basel II would be a lower capital requirement. If an organization has reduced its required capital from the implementation of Basel II, that capital can be invested in other earning assets. The reinvested capital may increase earnings per share and return on equity. (It should be noted that the ability to reinvest Basel II capital savings is contingent upon the target capital ratios for "well-capitalized" institutions to remain the same.)

  Another potential significant advantage of adopting Basel II is the expected improvement in risk management practices. Although we realize that organizations can implement these practices without "opting-in" to Basel II, we believe that Basel II can act as a catalyst to accelerate the evolution of a comprehensive risk management program for an institution. The risk management program required by Basel II will create significant value to an organization in terms of reduced losses, a stronger internal control environment, operational efficiencies, and improved deployment of capital.

  Finally, another possible benefit will be the perception of the markets. The more sophisticated credit risk and operational risk management techniques associated with Basel II should give an additional measure of perceived safety from the perspectives of stockholders, investors, analysts, and customers.

  There are many possible competitive benefits. However, these benefits come at the cost of enhancing the credit risk and operational risk processes and systems. Accordingly, the decision to Opt-In, like many strategies employed by businesses, becomes one of a cost benefit analysis. If the benefits of Basel II out weigh the costs, an institution would "opt-in." At Sovereign Bank, we are continuing our analysis of the costs and benefits of adoption.

  See also our **Comments on the OTS CEO Memorandum** (See Question # 1 below)

Comments on the Advanced Internal Ratings Based (A-IRB) Approach

We have reviewed the formulas for the calculation of the capital requirements under the A-IRB approach as they are described in the ANPR. Based on our review, we have noted the following concerns with parameters and assumptions used in these formulas:

- Retail – Mortgage - The Asset Value Correlation ratio (AVC) is set too high at 15% for this category, which includes both first and subsequent lien loans (including home equity lines) secured by 1-4 family residences. This level is 1.5 times the industry median. Also, the Loss given default (LGD) floor of 10% is inappropriate for loans with low loan-to-value (LTV) ratios. This may unduly penalize institutions with seasoned residential mortgage portfolios. The Agencies should also note that, in the United States, the process of title tracking and recording of property data is superior to that of other nations. This fact, coupled with the industry standard of obtaining credit reports, credit risk weightings, such as FICO scores, title insurance, and hazard insurance makes loss, due to reasons other than borrower default, relatively negligible. Secondly, many subordinate lien mortgage loans are in fact first lien position. Based on these factors, we believe the higher AVC ratios proposed will inappropriately penalize many institutions.

- Retail – Qualifying Revolving Exposures (QRE) - This category includes credit cards and overdraft lines. We believe the AVC ratios for the QRE loans are also set too high. The top ends of the range at 11% and 17% are in excess of industry norms. We urge the Agencies to reconsider these parameters. Also, we look forward to an updated proposal which eliminates the expected loss component of the QRE formula.

- Retail – Other Retail (Installment) – We are concerned with one of the basic assumptions in this category which includes auto loans, student loans, consumer installment loans (other than home equity), and some SME loans. The ANPR describes the inverse relationship between the AVC and the Probability of Default (PD). Under this assumption, high quality auto loans will have higher capital charge due to the low AVC. We believe that this assumption will unfairly penalize institutions with high quality auto loan portfolios. Additionally, for reasons already noted above, the United States has a more sophisticated industry in determining credit risk compared to other industrialized nations, which makes default other than borrower relatively negligible.

- Securitizations - We are encouraged about recent news on the BCBS decision to drop the "supervisory formula" for calculating capital requirements for securitized assets. We urge the Agencies to also support simplicity in calculating the capital requirement for secruritizations.

  Some of our other concerns include the capital requirements for senior positions held by originating banks. The requirement to deduct senior positions originated, which are in excess of K-IRB, contradicts the treatment for senior positions purchased. We also believe banks should be allowed to use external ratings.

- High Volatility Commercial Real Estate (HVCRE) – The ANPR has indicated that all Acquisition, Development, and Construction (ADC) loans should be treated as HVCRE. An exception is allowed for ADC loans with substantial equity, or which are sufficiently pre-sold. However, we believe that, even with this exception, the definition of HVCRE is too broad. We believe that the residential construction component does not belong in the HVCRE category.

Comments on Disclosure Requirements

We generally support increased disclosure that provides relevant information to our customers, investors, analysts, regulators, and other constituents. However, we have several essential issues that must be considered in developing the disclosure framework for Basel II.

- A balance must be determined as to the frequency, timing, and amount of disclosure, which considers the cost to organizations and materiality, as well as competitive conditions in the market. Disclosure of competitive information that could damage institutions must be avoided.

Comments on Disclosure Requirements - continued

- The Agencies must make a final determination as to whether a bifurcated capital system will exist. We would be very concerned if there were different rules with respect to disclosure for Basel II institutions, as compared to banking organizations which do not adopt Basel II.

- Any disclosure requirements should consider the existing standards under generally accepted accounting principles (GAAP), as well as regulatory disclosures mandated by the Agencies, the Securities and Exchange Commission, etc. We would strongly endorse harmonizing the financial disclosures required by local GAAP, where applicable, with any guidelines implemented under Basel II.

Draft Supervisory Guidance (No. 2003-28)

Comments on the Draft Supervisory Guidance on the A-IRB Approach for Corporate Credit

In our Comments on the Advanced Approaches above, we noted certain concerns regarding implementation of the A-IRB approach, which were presented in the ANPR. The following comments are on the supervisory expectations of an Internal Ratings Based System (IRB) which were presented in the Draft Supervisory Guidance in the Federal Register. Our comments cite our concerns with the Agencies' expectations of IRB systems which Basel II institutions are required to develop.

- Ratings for IRB Systems - Sovereign Bank expects to introduce an expanded risk rating system that increases granularity of obligor risk ratings and introduces a facility risk rating dimension. We are concerned that supervisory oversight of this risk rating system and its implementation appropriately will take into account that the rollout would be occurring concurrent with development of the bank's IRB system. Therefore the PD and LGD calibration and validation will not take place until after the IRB system is in place

- Quantification of IRB System / Data Maintenance - We are concerned with the suggested timeframes for reference data; 5 years (PD) and 7 years (LGD). There are obstacles to the availability and integrity of loan data from prior years. When the events underlying historical data occurred, we did not contemplate the granularity and format of data required by Basel II. Many of our loan portfolios have been assembled from multiple bank acquisitions. Accordingly, histories are not as neatly or easily obtained. We believe that the obstacles we anticipate in obtaining the suggested data will also be experienced by other banks. For certain wholesale portfolios, the PD sample requirement for 5 years of data does not satisfy the additional requirement that the reference data set must include periods of economic stress where default rates were relatively high. For instance, CRE portfolios in our markets have not experienced high default stress for over 10 years.

- Control and Oversight Mechanisms - Implementing the IRB System places an increased burden and related costs on the governance and oversight resources of the bank. Just as the bank must develop and/or acquire the staffing expertise and technology to satisfy the standards of an acceptable IRB system, the oversight functions of the bank, including loan review, internal audit, and the board of directors, must also invest in developing the expertise to handle oversight and control of this new activity.

Comments on the Draft Supervisory Guidance on the AMA for Operational Risk

Implementation

The framework for the AMA presented in the Draft Supervisory guidance, as well as guidance provided by the Bank of International Settlements (BIS), provides a general structure for developing an operational risk system. However, many aspects of the framework require more specific guidance.

We believe that the requirement that Core Banks and Opt-In Banks use only the AMA approach is too restrictive. We suggest that the Agencies consider allowing use of the Basic and Standard approaches until such a time that the AMA has been more clearly defined and codified. We believe it should be

desirable to migrate towards utilization of the most advanced approaches. Organizations should have a documented plan in place to migrate toward the AMA method over a defined period.

Advanced Management Approach

The main impediment with applying the AMA is that a significant amount of relevant data and a thorough understanding of that data are required to produce sound quantitative results. The proposed legislation requires precision and validation, even though the modeling of operational risks is not a mature practice. The following are certain concerns regarding application of the AMA approach:

- For most banks, current operating risk data will not be sufficient for sound modeling. As such, more detailed data accumulation techniques and systems will be required to implement the AMA.
- Each type of operational risks may have it's own loss distribution subject to business area and risk management practices. Other concerns on loss distributions include the following:
  - We believe that the 99.9% confidence limit results in overstating the capital need when summed across individual Operational Risk distributions. The ANPR provides for a correlation adjustment; however, most institutions will not have the data necessary to substantiate the actual correlation. This may suggest lowering the requirement until institutions can gain some experience with outside sources that provide this kind of correlation data and/or simulations addressing all significant Operational Risk simultaneously.
  - External data may be useful; however, "scaling" it to your own bank requires significant judgment. The configuration of your operations and application of best practices will be lost. More time, research, and general education is needed.
  - Loss data and distributions are constrained by each banks own practices, judgments, and risk appetite. Coming to the 'right' conclusion requires thoughtful analysis.
- Banking organizations will require more specific guidance in applying limits, mitigates, and qualitative factors. It would be helpful if industry data were available. This is not just a concern of US banking organizations, but a global issue if we expect fair comparisons.
- Early versions of operational risk management software are not mature yet. Even if the new software has appropriate analytics, the amount and quality of the data may produce widely varying results. Fitting heavy tailed distributions and extreme value theory calculations can produce widely varying capital needs from year to year when based on small amounts of data even though the calculations can be made[1].
- The 20% cap for insurance as a mitigate seems arbitrary. We are concerned that this will eventually be used as a bright-line for other mitigates.
- Some guidance should be given as to the relationship among 99.9% confidence limit, scenarios for testing, and a catastrophe (level where capital relief is impossible).

In summary, we believe there is extensive work remaining at the individual bank level, and the Agencies with respect to data, scenario analysis, and the overall framework of AMA. We would like to see the Agencies propose progress incentives by allowing a sequence of capital estimation methods leading ultimately to AMA. We believe that this approach would provide a larger population of institutions a substantial incentive to implement more sophisticated operational risk management practices, which in turn will promote improved safety and soundness in the industry.

[1] See *Modeling, Measuring and Hedging Operational Risk* by M. Cruz pages 277 – 281.

Comments on OTS CEO Memorandum #177

CEO Memorandum #177 listed five questions which thrift institutions should consider in conjunction with their comments on the proposed Basel legislation. These questions are listed below along with Sovereign's comments:

1.) Would Basel II present a general disadvantage to your organization? – Sovereign Bank does not meet thresholds to be considered a "core" bank. However, we are currently evaluating whether to "opt-in" to Basel II. We find the opportunity to evaluate this option challenging and are currently weighing the advantages and disadvantages of adopting the new capital accord.

Based upon the results of the Quantitative Impact Study (QIS), it appears that the implementation of Basel II may result in a net reduction of capital required for certain institutions. This can be seen in the QIS summary, which showed that the average US institution reduced their capital requirement by a net factor of 2%. This is an average, however, and includes banking organizations in which capital requirements increased, as well as those which experienced a decreased requirement. Since the new capital rules are more risk sensitive than the 1988 accord, institutions which have predominantly high risk assets (as defined by the new accord), will see their capital requirements increase, while institutions with low risk portfolios will see capital requirements decrease. Therefore, the advantage of Basel II implementation would be expected to accrue to those institutions with low risk portfolios.

Another noteworthy benefit of Basel II is that the requirements will raise the standards significantly for credit and operational risk management. The organizations which adopt Basel II will have clearly defined objectives for improving their risk management practices and internal control environment. We do believe that implementation of enhanced risk management practices, which are integral elements of Basel II would provide an advantage. Sovereign has implemented certain risk management processes and systems and will continue to enhance its overall risk management and internal control environment regardless of its final decision as to whether it will "opt-in" to Basel II.

Accordingly, we believe that Basel II does not present a general disadvantage to our organization.

2.) Should a single, risk-based system be devised for all institutions? We understand it is expected that there will be 10 institutions which would be required to adopt Basel II as "core" banks, and possibly another 10 which would voluntarily "opt-in." The result will be a bifurcated capital framework, with approximately 20 institutions utilizing Basel II capital rules, while the remaining banks and thrifts (approximately 9,300 institutions) will continue to apply the existing capital framework.

This environment is in contrast with the single risk-based system that currently exists. This current capital framework has created a level playing field under which most US banking organizations have thrived. The single capital framework has created a common capital metric that does not give an advantage to selected institutions. This level playing field allows institutions of various sizes and profiles to compete for customers. The result of that competition being high quality, low price banking products. Accordingly, we believe that a single capital framework is preferable.

The potential implications the new rules to create a bifurcated capital system are significant, and should be addressed thoroughly, and with the utmost care. We believe that the OTS, as well as the other US regulators, should single out this issue as a critical one, and develop consensus that has broad support of all constituents. We look forward to participating in this process in tandem with the Agencies.

(See also **Comments on a Bifurcated Capital Framework** above)

3.) Would Basel II create pricing advantages for certain institutions? – We believe that Basel II may create pricing advantages in some circumstances.

In most institutions, the cost of capital is a consideration in the pricing of a loan. Since Basel II will give more favorable capital treatment to low risk loans, it is possible that these savings may be passed on to the customer in the price of the loan. Conversely, under Basel II banking organizations which hold higher risk loans will not yield capital savings and, consequently, will probably not reflect any reduction

of price. It seems to follow that Basel II might create a greater price spread between low risk and high risk loans.

In summary, it is probable that there will be pricing advantages for Basel II institutions which realize a capital savings. However, we do not think that this result will be inappropriate. There are already pricing discrepancies under the current capital framework, which may arise from different reasons such best practices in pricing, highly capitalized institutions, and geographic or regional trends. Accordingly, we believe that the pricing advantages realized from Basel II will not be significant and will not adversely affect the US banking industry.

4.) Would Basel II promote further industry consolidation? - We do not believe that Basel II, by itself, will be a major impetus to cause a wave of consolidations. However, we do believe that Basel II will become a new criterion to add to the many decision points involved in acquisition decisions.

If the proposed bifurcated capital framework comes to fruition, Core and Opt-In banks may see the potential capital savings embedded in an acquisition target. As such, there may be opportunity to arbitrage the different capital methods. For example, a smaller institution, which is under the old rules, may have some capital savings embedded in its portfolio that a larger institution could take advantage of if the new capital rules were applied to those assets as a result of an acquisition.

In summary, we believe that Basel II, in itself, will not be a significant cause of industry consolidation. However, the potential to realize embedded capital savings might be a contributing factor in evaluating a target.

5.) Would Basel II require the agencies to consider changes to the Prompt Corrective Action leverage ratio requirements? – The prompt corrective action ratios (PCA) were designed by FDICIA and FIRREA to serve as a trigger for supervisory action. As such, these ratios serve as benchmark for safety under the Basel accord of 1988. These ratios, which were calculated under the existing capital rules, included a minimum total risk based capital ratio of 8%. This target was set considering the existing regulatory capital framework, which is not as risk sensitive as the new rules. The question above considers whether the 8% target can also be applied to the new Basel II capital framework which is risk sensitive.

Since the Basel II capital calculation is risk sensitive, banking organizations which invest in predominantly lower risk assets should see an improvement in their capital ratios. Conversely, those institutions, which have invested in predominantly higher risk assets, will see a reduction in their capital ratios under the new risk sensitive rules. Therefore, the new capital rules will emphasize the safety of low risk institutions, while highlighting the risks of problem institutions.

Based on these ideas, we believe that the PCA ratios do not have to be changed. We must assume that the original PCA target of 8% was set with a buffer to reflect the differing risk levels not considered in the old capital rules. Accordingly, the new capital rules may result in a higher capital ratio, however, the risks have been reflected in that new ratio.

Recent Developments

We have been pleased with the recent statements from the Basel Committee on Banking Supervision (BCBS). We are in agreement with the dropping of the requirement to provide capital for expected losses. We are also pleased to see BCBS shifting to a simpler and less prescriptive approach. We hope the US Agencies will harmonize the US implementation with the new positions of the BCBS.

Conclusion

We again would like to extend our appreciation to the Agencies in providing this forum under which we could share our comments on the New Basel Capital Accord. We are very supportive of creating a more risk sensitive capital framework. We believe that this will provide institutions with incentive to expand advanced risk management practices. These practices will improve organizational profitability and efficiency as well as contribute to overall improved safety and soundness of the industry.

The possible advantages, disadvantages, and consequences of the new rules should be evaluated extensively with input from all constituents. In particular, we would encourage in depth analysis of the potential effect of a bifurcated capital framework. In addition, we believe it would be very beneficial to consider the implications of using a broader approach to measuring credit risk and operational risk in the proposed capital framework.

Sincerely,

James D. Hogan, CPA
Executive Vice President
Sovereign Bank
Chief Financial Officer
Sovereign Bancorp, Inc.

Dennis S. Marlo, CPA
Chief Risk Management Officer

Robert Rose
Chief Credit Officer

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CC: OTS Northeast Regional Office