FleetBoston Financial

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November 3, 2003

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Secretary
Attention: Docket No. R-1154
Board of Governors of the Federal Reserve System
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Washington, DC 20551
regs.comments@federalreserve.gov

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
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Office of the Comptroller of the Currency
Attention: Docket No. 03-14
250 E Street, SW
Public Information Room
Mail Stop 1-5
Washington, DC 20219
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Regulation Office
Chief Counsel's Office
Attention: No. 2003-27
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
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Re: Risk-Based Capital Guidelines; Implementation of the New Basel Capital Accord; Proposed Rule and Notice

Ladies and Gentlemen:

FleetBoston Financial Corporation ("FleetBoston") is the seventh largest diversified financial holding company in the United States with total assets of U.S. $197 billion. Headquartered in Boston, Massachusetts, FleetBoston has consumer and commercial banking platforms, as well as asset management and capital markets businesses, serving approximately 20 million customers worldwide.

The U.S. version of the New Basel Capital Accord ("New Accord"), issued for comment in August 2003 as the Advanced Notice of Proposed Rulemaking ("ANPR"), would have a significant impact on our institution and on the banking industry in general. As such, we appreciate the opportunity to provide the U.S. bank supervisory agencies ("Agencies") with our thoughts and concerns regarding the ANPR.

FleetBoston commends the Agencies for their continued work with the Basel Committee on Banking Supervision ("Committee") to improve the proposed rules. The Third Consultative Paper on the New Basel Capital Accord ("CP3"), on which the ANPR is based, is a significant improvement over the previous version, especially in the calculation of minimum regulatory capital in Pillar I. We believe this stems from the Agencies' openness to industry comments and suggestions and their willingness to incorporate capital "best practices" into the rules. We especially appreciate the proactive process by which industry input has been solicited.

This letter offers FleetBoston's specific comments and concerns with the rules as presented in the ANPR, as well as the supervisory guidance released simultaneously in the Internal Ratings-Based Approach for Corporate Credit ("AIRB SG") and the Operational Risk Advanced Measurement Approach for Regulatory Capital ("AMA SG"). Much of the substance of this letter is unchanged from our response to CP3 dated July 31, 2003 because the advanced approaches incorporated into the ANPR are largely unchanged. We have attempted to provide additional color on many of the topics plus additional detail not covered in the previous letter. You will see that our responses are divided into two sections: (a) foundation issues that are of major concern and (b) implementation issues.

Many statements and related stories have been disseminated following the October, Madrid conference of the Basel Committee, indicating that certain key elements of the New Accord have been modified and/or clarified. We have restricted our comments herein to the existing ANPR, which does not include any of these potential changes. Once the final decisions of the Madrid conference are agreed to and disseminated, we will provide feedback on these modifications.

FOUNDATION ISSUES

A Full Internal Models-Based Approach for Regulatory Capital should be adopted. FleetBoston commends the Agencies for their attempt to improve upon the regulatory capital rules originally laid out in the 1988 Basel I accord. The goal of more directly linking the levels of regulatory capital with underlying economic risks is key to this improvement and one that we wholeheartedly support. Many large banks, including FleetBoston, have been managing their business for years using risk-sensitive internal economic capital models. Drawing on our own experience, the economic capital process has proven quite successful in the management of risk, the allocation of capital, servicing our customers effectively, and improving returns to our shareholders. While the advanced approaches are an improvement over the existing rules of Basel I, it is our strong belief that the use of the computation methods proposed by the ANPR would result in a process that falls short of achieving a truly economically-based, regulatory capital methodology. We will elaborate further throughout this letter.

FleetBoston recommends that a bank's regulatory capital should be determined solely using its internal models, regardless of risk type (i.e., credit, market, and operational risks). Naturally supervisory oversight, review, and approval would be required. In the ANPR, we see specific areas where reliance on internal models is accepted: the internal models-based approach for equity exposures, the existing market-risk capital process, and now in the AMA for operational risk. We question why a full commitment to the

use of internal models is not pursued for credit-risk capital. With credit risk, data is plentiful and increasingly available, quantification techniques are well developed, and the market practices to both price and hedge risk are improving every day. Yet with all this, the ANPR continues to provide a great deal of prescription that in total arrives at capital results that are too conservative. In contrast, the determination of operational risk capital, a discipline very much in its infancy, is required to make use of a bank-developed AMA. An internal models-based approach incorporates flexibility and simultaneously ensures that regulatory capital appropriately reflects economic risks; as such, we believe that capital allocation for all risks should be addressed through this approach.

Regulatory Capital for Expected Losses is inconsistent with Financial Theory and Industry Practice. The New Accord, and hence the ANPR, leave the definition of regulatory capital unchanged from the current rules. We believe this has forced the Agencies to treat regulatory capital as covering expected losses in addition to unexpected losses. This practice is inconsistent with financial theory and industry practice, where capital provides protection against unexpected losses only. Typically, economic capital consists of common equity and is used for protection against unexpected losses only. That is, capital protects against the volatility of actual losses around the long-term average or expected level. Unfortunately, having different meanings for the term "capital" has been a barrier to effective communication about the similarities and differences between regulatory and economic capital methodologies, often leading to confusion and a lack understanding of the New Accord. Additionally, the Agencies have had to incorporate "work arounds" into the ANPR (e.g., inclusion of Future Margin Income, "FMI") to ensure that capital is not required where income has already been provided to absorb expected losses. This adds unnecessary complexity to the rules.

Expected losses are a recurring "cost of doing business" that are explicitly incorporated into all transaction pricing, particularly for credit products. Consequently, losses are charged against income as incurred or via a provision to build a reserve. To require capital for expected losses suggests that actual credit charge-offs or operating losses should be charged directly against capital, not earnings. If this were so, then banks would be freed from the need to charge these losses against earnings, as they have already set aside capital.

FleetBoston recommends that the regulatory capital methodology be revised to cover the potential for unexpected losses only. However, if the Agencies continue to pursue the approach of covering both loss-types, then (1) all of the loan-loss reserves should be included as regulatory capital; and (2) a credit to regulatory capital that reflects all of an institution's earnings power should be provided (i.e., the inclusion of all the Future Margin Income needed to cover expected losses and not just the limited amount as proposed in the ANPR). In addition, we view FMI and loan loss reserves as our "first line of defense" against potential losses. Consequently, we believe that these two forms of protection should count as Tier 1 capital not Tier 2.

Recently, the Basel Committee on Banking Supervision ("BCBS") released a statement detailing an approach for regulatory capital that will cover unexpected losses only. Included in this proposal is a redefinition of regulatory capital. We are pleased to see the supervisory authorities considering this needed change to the New Accord. As discussed earlier, we will offer our comments on this proposal in a separate letter to be submitted after completion of these comments.

The proposed capital floors are inappropriate given the best-practice standards identified and the disincentives that are created for non-core institutions. First, with all the effort expended over the past five or so years by the supervisory community and the banking industry on the New Accord, we

believe it is a mistake to restrict its ability to function as designed. The first year (90%) and second year (80%) risk-weighted asset floors, which effectively limit the regulatory capital reduction available from the ANPR, impair the Accord's effectiveness and reduce incentives for banks to devote the resources needed to adopt the advanced approaches. We understand the need for some amount of conservatism, but not the exclusively unidirectional way in which it is applied here. We believe that these floors should be removed, allowing the methodologies in the Accord to function as intended, with regulatory capital requirements reflecting true, economic risks. Supervisory oversight can be invoked as needed to have institutions alter their capital levels if the proposed rules do not properly reflect the risk profile. If, however, the Agencies decide to retain these floors, then we urge that caps, similar in nature to the floors, be instituted.

Credit Risk Capital is too conservative. We believe that the calculation of capital for credit risk includes several adjustments, which individually seem reasonable, but collectively are too conservative. Some examples include: (a) the LGDs on residential mortgages have a floor at 10%, (b) not providing the full regulatory capital benefit provided by Future Margin Income ("FMI") (e.g., only 75% for qualifying revolving retail exposures and nothing for other credit products), (c) not recognizing the full risk-reduction benefit provided by guarantees through "joint probability of default," and (d) the strict matching required for the risk reduction provided by credit default swaps.

We believe that supervisory review and validation of bank PDs, LGDs, and EADs — a prerequisite for the use of internal data in the regulatory capital calculations — provides enough oversight without additional minimums and maximums, which themselves appear arbitrary. During the internal model certification process, concerns surrounding assumptions and data calculations should be raised and addressed. It should not be assumed, *a priori*, that the inputs are required to be more conservative using rules-based procedures. If, during the validation process, examiners conclude that a bank has not shown proper back-up or sufficient justification for its inputs, supervisors can then require additional conservatism in the parameters. The advanced approach is, by its nature, the best method to assess economic risk. Arbitrarily constraining the results of such risk assessment would seem to send an unintended message to bank management. Why, for instance, would management require mortgage borrowers to have private mortgage insurance ("PMI"), a prudent risk management action, when it receives only partial regulatory capital relief?

Further, we point to the statement within the AIRB SG (page 45960), in the context of credit-risk parameter estimation: "Margins of conservatism need not be added at each step; indeed, that could produce an excessively conservative result." The cumulative effect of the requirements, including stressed PDs and LGDs, would appear to be inconsistent with the intent of avoiding an excessively conservative methodology.

These restrictions will continue to invite capital arbitrage, which undermines the New Accord at its inception. With regulatory capital continuing to be significantly more conservative (i.e., higher) than the economic risks would suggest, efforts to circumvent the New Accord will continue (i.e., opportunities for regulatory capital arbitrage would continue to be available). This result could be eliminated up-front through a closer alignment of capital with the economic risks.

For all the reasons above, FleetBoston strongly urges the Agencies to adopt the Advanced IRB approach without any specific supervisory minimums for the major inputs. It is our view that this would also motivate non-core institutions to move towards a more robust risk-management framework.

A Specific Capital Charge for Operational Risks is inappropriate at this time. In general, we support the Agencies' desire to develop a quantitative methodology for operational risk capital. Our view is that the current state-of-the-art practices for operational risk measurement and the collection of the loss events needed to develop and calibrate the models have not progressed sufficiently to warrant their use in the assignment of a minimum regulatory capital charge at this time.

We continue to believe that the measurement of operational risk is an emerging discipline of research that is an important risk management area for the industry and its regulatory authorities, and that capital should ultimately be assigned for this risk. While good progress has been made in the quantification of the risk, much important work remains before a capital charge can be determined. These tasks include:

- Collection of enough historical loss-event data to be statistically meaningful. This applies both to an individual bank's collection of its internal loss events and to the collection across the industry in total.
- Development of accurate and conceptually sound quantitative techniques needed to transform loss data into capital requirements.
- Resolution of context-dependency issues within the same institution, reconciling loss-event data across lines of business, and within the same line of business where the business model, internal control factors, or other foundation variables have changed dramatically.
- Incorporation of external loss data into individual bank capital calculation requirements with as yet unperfected methods of scaling these data to a bank's activity level, as well as for the differences that exist in control environments.

While capital is an important component of a bank's risk management toolkit and can provide meaningful protection against unexpected operating loss events, the cost of operational risk is typically a "cost of doing business" to be covered through current period operating earnings. Banks have made a significant investment in risk-mitigation costs, such as establishing and maintaining risk-control systems, internal and external audit oversight, and insurance protection. All of these form the first line of defense against the effect of operational errors and are paid for through charges against annual earnings. With all the focus on capital that the New Accord and the ANPR bring to bear, we fear that these time-tested risk mitigation and control techniques will be potentially overlooked, opening the door to significant losses.

In addition to the quantification challenges, a specific capital charge does, in our view, create an uneven playing field. Products and services that are primarily operating in nature form a significant source of revenue and profit for FleetBoston through our ability to serve our customers' complete financial needs. Our concern is that a specific capital charge will put us and the global banking industry at a competitive disadvantage vis-à-vis non-bank competitors who are not subject to the same rules.

At this time, FleetBoston urges the Committee to remove the explicit capital charge for operational risk from Pillar I and to include the assessment of this risk as part of the examiners' periodic reviews of a bank's risk profile (i.e., Pillar II approach in the vernacular of CP3).

Our recommendation is not without precedent. The assessment of structural interest rate risk (i.e., that which resides in the basic banking book) has been recognized as an explicit risk long before operational risk, and has been the explicit cause of a number of bank failures in the past. The measurement processes are very well developed and have undergone extensive scrutiny by the industry, supervisors, and academicians. All would agree that there is some level of economic risk here, but the Agencies have

decided, and we strongly agree, that this risk is better handled within a supervisory review framework unless a bank is running an extreme position.

We continue to believe in a supervisory review (Pillar II) approach for now. If, however, the Agencies decide to continue with a Pillar-I capital charge for operational risk, the AMA approach appears to be a "distant second" option, but may provide workable solution. As we stated earlier, allowing a bank to use its internally-developed data and models, with regulatory oversight of course, will generate a more accurate representation of the underlying risks, which will in turn result in a more accurate level of regulatory capital. Additionally, we feel that an AMA affords the desired flexibility, including the reduction in risk afforded by insurance, and lack of prescriptiveness needed at this stage of development. Forcing banks to use a particular approach when industry, market, and supervisory "best practices" are still very much in the development phase would be a mistake. At this point in the development of operational risk measurement, supervisors need to encourage the creation of multiple innovative techniques, which we believe the AMA allows.

We understand the dilemma with which the Agencies are faced, balancing standardization of rules to foster comparability versus recognizing differences to allow for flexibility. The AMA provides ultimate flexibility but is lacking guidance on how an examiner is going to determine if a bank's process is certified for use as an AMA. This issue requires additional discussion and specificity.

In any event, FleetBoston urges continued collaboration between the industry and the bank regulatory authorities in advancing risk assessment techniques for operational risk.

The capital-reduction benefit of Line-of-Business (or risk type) diversification should be incorporated into the new framework. Nowhere in the ANPR is there a capital benefit provided to banks that operate a diverse mix of businesses. Business-line diversification, or alternatively risk-type diversification, mitigates both the possibility and magnitude of unexpected loss, and as a result, banks should be allowed a capital credit or risk-weighted-asset reduction in recognition of such diversification. For a well-diversified institution, there is a decreased probability of a bank experiencing significant losses in each of its businesses simultaneously. For example, the ANPR would determine capital for a bank operating only two business lines — let's say consumer banking (primarily a credit-risk activity) and asset management (primarily an operational-risk activity) — as the simple addition of credit-risk capital and operational-risk capital, computed independently. We feel this approach overstates the institution's total risk and as a result, the amount of regulatory capital required. In addition, ignoring the benefit sends an inappropriate message that diversification of risk provides no capital benefit, which we believe is incorrect.

We offer two examples in support of this risk-diversification benefit. First, banks consider this benefit in their economic capital models. FleetBoston has developed internal estimates of the capital reduction that comes from its existing mix of businesses. The results demonstrate that business-line diversification allows FleetBoston to reduce its economic capital from the levels that would result from the simple addition of the stand-alone capital needed for each business. JP Morgan Chase publicly discloses a capital-reduction benefit from diversification of about 16%.[1] We are not suggesting the appropriate level of diversification benefit that would be determined by an individual bank's business mix and risk profile. Instead, we are attempting to point out that banks recognize its value in their economic capital models and in the management of capital.

[1] JP Morgan Chase 2002 Annual Report, page 41.

Second, in our informal discussions with external rating agencies, they acknowledge that diversification is an inherent risk mitigant and is reflected in their ratings of financial institutions. For example, monoline credit card companies are viewed as riskier than well-diversified financial institutions, all else being equal. This can clearly be seen in the higher levels of capital required by the markets for concentrated businesses.

FleetBoston strongly suggests that any final rule must include a reduction in regulatory capital for the benefit of line-of-business diversification, at the total bank level.

The following example provides a simple approach on how the benefits might be computed using a sliding scale and the businesses outlined in the operational-risk proposal of CP3.

> In the consultative document, there are eight Level-1 business units.[2] To qualify for any decrease, an institution must first have at least two business units that each contributes at least 10% of the bank's annual pre-tax net income. This would set a base reduction in the amount of 6% of the aggregate regulatory capital requirement. For each additional business that contributes at least 10% of annual pre-tax net income, an extra 1% reduction in regulatory capital would be provided. Therefore, a monoline bank receives no diversification benefit, while those with two to eight businesses can have total regulatory capital reduced by an amount ranging from 6% to 12%. While conservative correlations of 0.75 were assumed in creating the preceding example, it is meant to suggest a framework to quantify a benefit we feel is warranted, meaningful, and quantifiable

The ANPR results in an Uneven Competitive Playing Field. As with the current regulatory capital rules, the ANPR applies only to banking firms. This continues to leave non-bank competitors free to pursue their business activities unencumbered by supervisory capital rules. Two examples come to mind: commercial real estate ("CRE") and operating services (e.g., asset management). We, and other U.S. banks, compete against captive finance companies, insurance companies, and investment banks for CRE business. In operating services, the non-bank competition is largely from investment banks and other independent service providers.

We feel that this approach will result in assets or businesses flowing from the banking system to entities without these capital regulations. This result hurts banks' earnings potential, making them more susceptible to economic downturns. We have heard arguments that banks have advantages (e.g., access to discount window borrowings in time of liquidity stress) that are paid for through strict regulation. In spite of this, national banking regulators need to be aware of unintended consequences. For example, with the potential for so many activities to be conducted outside the banking system, the ability of national regulators and central bankers to control systemic risks is greatly reduced, which could pose threats to the stability of national, as well as global financial systems.

Another potentially adverse competitive element of the New Accord relates to interpretations. It appears that supervisors in each country are allowed wide discretion to interpret the New Accord as they see fit—witness the decision to adopt only the advanced approaches in the U.S. This could provide banks in a particular country operating under a more favorable interpretation of the capital rules with a distinct

[2] Annex 6, page 199, *Consultative Document — The New Basel Capital Accord*, April 2003

competitive advantage. Often this is referred to as the "home / host" issue and will be a concern for all banks not just internationally active ones. For instance, a non-indigenous bank may be able to attract business and customers from local banks if it is operating under a less-restrictive interpretation of the New Accord provided by its "home" regulator, which in turn allows for lower pricing on products and services. Therefore, great care needs to be taken to ensure this does not happen and that a standard and uniform interpretation of the proposed rules is used by all global regulatory agencies. While we have reviewed the *High-level principles for the cross-border implementation of the New Accord* published by the Basel Committee in August and understand that an Accord Implementation Group has been established to deal with these concerns, we have not yet seen the definitive rules or explicit guidance required to resolve this issue.

Similarly, it is not clear from the ANPR how uniformly the advanced approaches will be applied across subsidiaries of core institutions. This issue must be addressed consistently by all regulators across the globe.

The Asset Securitization Capital calculation is unnecessarily complex. First, we welcome the Committee's approach that caps the regulatory capital requirement in situations where a bank retains first-loss exposure in a securitization of its own assets (i.e., banks as an issuer in securitizations). Any set of rules that results in more capital after a securitization than if the assets remained on a bank's balance sheet is fundamentally flawed. Under the proposed approach, banks that have on-balance-sheet, credit-enhancing IO strips first must deduct these positions from capital and thereafter apply the AIRB cap. This process could result in capital charges that exceed the capital requirements of the "non-securitization" alternative mentioned above. We feel that the maximum capital charge should by capped by the AIRB capital including the IO deduction.

Securitization of assets is an important liquidity management tool for banks, since it represents funding with limited issuer event risk and enables banks to tap a non-traditional funding base, which ultimately lowers liquidity risk through the diversification of funding sources. We are strongly opposed to any capital rules that do not accurately reflect the economic risks and benefits of securitization.

FleetBoston's fundamental belief is that capital for securitization activities should be based on the results of a bank's own internal models and subject to regulatory review. Banks participating in these markets have devoted significant resources developing their own, economically-based models to understand the risks inherent in the pool of assets backing the securities issued to investors and retained by the firm. The bank's evaluation of economic risks is further validated by the rating agencies as both issued securities and retained interests are frequently rated. In addition, since these securities are sold in the capital markets, the issuer is able to receive further independent confirmation as to the economic risk inherent in these assets. We believe the calculation of retained economic risk should ultimately determine capital requirements.

As in other areas of the ANPR, the capital required under the proposed approach is too conservative (i.e., the capital is too high based on the underlying economic risks). This conclusion is based upon the results of a comparison of our own internal economic capital models with the results of QIS3. Also, the additional complexity of "K_{irb}", "L", and "T" terms does not materially improve the resulting capital requirements. As a simpler, more direct approach, institutions would first determine K_{irb} as proposed. Then, the needed capital would be the lesser of this amount or the total retained first-loss position. Capital requirements for other tranches held by the bank would utilize the AIRB approach to calculate their risk-weighted assets or the RBA, as proposed.

A bank that is an investor in a securitization should be allowed to use its own internal credit models in the determination of regulatory capital, which is consistent with our earlier comment on the use of internal models for all credit risks. While CP3's Internal Ratings-Based Approach ("IRB") is a welcomed improvement over the current rules and a step in the right direction, we feel that it still overestimates the capital needed based on the securities' economic risk, especially in the case of liquidity facilities. This is another example of the unnecessary conservatism that is used in the New Accord for minimum regulatory capital calculations.

Additional Disclosure Requirements are excessive and unnecessary. The ANPR requires that a bank using the advanced approaches make extensive additional disclosures about its risk profile and risk management processes. These disclosure requirements are fundamentally flawed and should be dropped from the proposal for several reasons. First, the additional disclosures will not achieve the intended effect of increasing market understanding of financial institutions. The market is sufficiently well informed already as evidenced by the size of the market for debt issued by financial institutions. A financial institution transacts business daily in a variety of capital markets by raising wholesale funding, issuing debt, and providing clients with risk-management products. All of these transactions require the market to constantly assess the financial institution's creditworthiness including, but not limited to, its capital structure. Market participants have ample opportunity and resources to evaluate credit risk with the information already at hand. If the market needs more information, it will demand it. We do not believe the Agencies have any unique insight into the additional information that may be required by the market to make the same credit decisions it makes today without these disclosures.

Complying with the disclosure process would be quite burdensome and costly. Much of the information exists in formats designed for internal use and access. To translate and transmit the data would require additional staff and systems to ensure that the data is available, understandable, and current. Our biggest additional burden would be the effort and resources to ensure that the ANPR disclosures are put into the proper context of the bank's risk profile and not misinterpreted. Oftentimes, analysts or investors have limited time in which to understand changes in a company's financial position. This can force them into generic assumptions (e.g., all banks are the same) or cursory reviews that lead to incorrect conclusions. For example, a simple disclosure of an increase in exposures in poor-quality PD bands may be picked up, but without consideration of mitigation techniques employed to offset this apparent increase in risk.

The disclosure requirements may also create additional securities law liabilities for financial institutions that are subject to U.S. securities laws. Capital reserves represent an implied view of future expected losses. Any required disclosure of a bank's assessment of its capital position is, by its nature, a "forward-looking statement" which litigants could use to bring suits under U.S. securities laws with the benefit of "20/20 hindsight". While securities laws provide some safe harbors that may mitigate this risk, it cannot be eliminated. This incremental litigation liability would not accrue to financial institutions that are not subject to U.S. securities laws. Ultimately this would represent a competitive advantage for those institutions. We also believe that forced disclosure of much of a bank's risk profile represents an unfair compromise of confidential and proprietary business intellectual property. Financial services companies, not regulated by banking authorities, would also gain significant insight and competitive advantages as a result of these disclosures. Ultimately, a weakening of the banking system could result, which clearly, is contrary to the objectives and intent of the rule. The disclosure requirement may also result in a constriction of credit availability to less creditworthy customers. Banks using the AIRB approach would have an added incentive to avoid extending credit to any borrower that could trigger a further disclosure of increasing risk positions.

Finally, we urge that the Agencies do not make these disclosure decisions in a vacuum. Any changes to the current requirements should be made in conjunction with the appropriate accounting oversight bodies and securities regulators, such as the FASB and SEC in the U.S. and IASB internationally. Lack of collaboration with other authorities would result in unnecessary and potentially all too frequent changes to the requirements. This would also provide a way to ensure that the proposed disclosures are relevant by consulting with these authorities prior to implementation.

IMPLEMENTATION ISSUES

Implementation timing must be reassessed. Given the extended horizon for finalization of the New Accord and the ANPR, and the foundation issues that are not yet resolved, we would urge the regulators to reconsider the U.S. implementation date of January 1, 2007. The feasibility of this deadline is further strained by the data-history requirements and data-collection challenges faced by core institutions, both across specific commercial-credit segments and within the operating-risk area. Within the commercial-credit discipline in particular, this deadline will be challenging, given the 5-year data-history requirements for PD estimation and the 7-year data-history requirements for LGD and EAD estimation. On a cumulative basis, the implementation deadline does not provide an adequate timeframe for core institutions, particularly given the requirement that these institutions must receive approval from their primary Federal supervisor by year-end 2005. At a minimum, we would urge the regulators to relax the data-history requirements and recognize the evolving nature of specific methodologies within core institutions.

The definition of default needs to be refined, to more accurately reflect credit risk in both the commercial and consumer areas. In the commercial-credit area, the definition of default should be consistent with market convention ("credit events" defining default in the credit-derivative market) and rating-agency practices (which focus on "failure to pay" and "non-accrual"). In particular, "silent defaults" by definition are not reflective of credit risk, and as such, their inclusion would serve to artificially increase PD, decrease LGD, with little or no incremental value added to the predictive ability of the rating system. .Similarly, leases of 'essential-use' equipment often remain current even while the underlying creditor has defaulted on other obligations. In fact, asset-based lending exists as a product *because* a specific obligor is "...unlikely to pay its credit obligations...in full, without recourse by the bank to actions such as liquidating collateral..." (one of the ANPR default-recognition conditions).

Further, as the ANPR states, for consumer exposures, "...default on one obligation would not require a banking organization to treat all other obligations of the same obligor as defaulted." This distinction is important, since it will avoid creating artificially high PDs and similarly low LGDs for specific products and segments. Consistent with this interpretation, for specific commercial segments, defaults should be defined at the *facility* rather than at the *obligor* level.

In the consumer-credit segment, one of the triggers for recognizing default is "...a distressed restructuring or workout involving forbearance and loan modification;" our behavioral experience demonstrates that a "re-aging" (for open-ended accounts such as credit cards) or restructuring (for closed-end accounts such as mortgages) as defined in detail within the FFIEC guidelines, are very successful in reducing default rates. Should the ANPR definition of default remain as stated, core institutions may loose incentives to restructure debt now deemed to be in default.

With respect to undrawn exposures, both commercial and consumer, general banks will hold less capital than core banks. Specifically, under existing rules, any undrawn consumer-credit commitments that are immediately cancelable (such as credit cards), attract no regulatory capital; similarly, any undrawn commercial-credit commitments that mature in less than one year attract no regulatory capital. Under the proposed rules, core institutions will have to hold capital against the full amount of any undrawn lines. At a minimum, we urge the regulators to upgrade the existing regulatory-capital guidelines, to create a consistent framework for the treatment of all undrawn lines, between general and core institutions.

Establishing floors on specific parameters is arbitrary, excessively conservative, and contrary to the intent of enhancing the risk sensitivity of regulatory capital. Specifically, the PD floor of 3 basis points penalizes high-quality portfolios, particularly in the consumer-credit area. A significant portion of our mortgage and home-equity portfolio consists of low-LTV/high-FICO product, with an empirically-robust PD estimate of less than 3 basis points. Similarly, the 10% LGD floor for residential mortgages, across all risk segments and without regard to private mortgage insurance (PMI) is unnecessarily conservative. For example, for a 60% LTV mortgage, the LGD floor implies a liquidation loss of 50% in the event of a default on the underlying loan. Finally, the minimum asset-value correlation (AVC) of 15% for residential mortgages is artificially high and significantly above our internal estimates.

To more precisely reflect credit risk, these parameters should be calculated using an internal models-based approach, and where appropriate, reflect a sensitivity to variables such as loan-to-value (LTV) ratios and FICO scores. Additionally, these floors are contrary to the Accord's stated objective of improving the risk sensitivity of regulatory capital. For example, the implied decline in regulatory capital requirements for the credit risk of prime mortgages is empirically supported by proven predictive variables (LTV, FICO, and behavioral scores), significant data samples, and experience.

We disagree with the proposed rule that material losses on loan sales should be treated as default. Such losses should only be recognized as a default if they are charged against the loan-loss reserve. It is not clear what constitutes "material" in this context. Further, the market price of any asset reflects numerous conditions, in addition to idiosyncratic credit risk. Also reflected are interest-rate risk, liquidity risk, event risk, sector risk, supply risk, etc. The ANPR assumes that idiosyncratic credit risk can be isolated in this context, and this assumption is incorrect. For example, for any fixed-rate instrument, an increase in market interest rates will create depreciation in that instrument's price; similarly, for a floating-rate instrument, an increase in market spreads will create depreciation in that instrument's price. What is not clear is the attribution of these interest-rate and spread changes across the risk spectrum identified above. Hence, given that all or any portion of market-sale losses cannot be consistently and reliably attributed to the idiosyncratic credit risk of the underlying obligor, requiring that any such losses above some arbitrary threshold be considered default is neither practical nor logical.

Further, utilizing the ANPR's definition of commercial default (i.e., (1)"...the banking organization determines that the borrower is unlikely to pay its obligations to the organization in full...; or (2) the borrower is more than 90 days past due on principal or interest on *any* material obligation to the organization"), would market-sale losses above some threshold automatically require default recognition across all obligations of the underlying borrower, regardless of whether that borrower was current on these other obligations?

The combination of scarce historical data for specific specialized lending ("SL") segments, such as commercial real estate ("CRE"), and the resulting capital requirements under the Supervisory Slotting Criteria ("SSC") approach may represent a significant competitive disadvantage for core institutions. Specifically, the SSC approach will result in significantly higher regulatory-capital requirements relative to the existing regulatory-capital framework. Hence, core institutions will be required to hold substantially more regulatory capital in these segments relative to general institutions when historical experience does not support this increase. Further, lending activities for these segments may migrate to non-regulated institutions, since these institutions will be able to support more aggressive pricing, driven by lower capital requirements.

The definition of and capital requirements for residual-value risk are unclear and potentially excessively conservative. When defining the treatment of residual-value risk for lease exposures, it is not clear whether the agencies are referring to actual residual book value, or the variation between the residual book value and the residual's fair market value. Regardless of which definition is intended, we urge the Agencies to reconsider a seemingly arbitrary assignment of 100% that appears to have no supporting empirical evidence. This approach gives no recognition to the durability and market value of the physical assets nor the ability of the lessor to extract value from the assets — a core competency of any experienced lessor. The Agencies should consider an approach that reflects actual historical experience, in terms of the realization of residual values. The experience at Fleet has been exceptionally successful, and it is important to ensure that capital allocation methodologies reflect the true, economic risks.

Given the inclusion of expected losses in the calculation of required capital, we believe that the entire amount of ALLL should be treated as regulatory capital. In our view, the loan loss reserve covers both EL and UL, in part determined by estimated loan losses over the next year (EL), and the remainder determined by external constituents like rating agencies, investors, etc. (UL). Because the ALLL in total represents the first line of defense against losses, we further believe that this amount should be included in Tier-1 capital.

While we support the Ratings-Based Approach ("RBA") for securitizations, the application of this methodology is not clear. For example, in Table 1 on page 45935, column 2 refers to "Thick tranches backed by highly granular pools", but neither the term "thick" nor any threshold thereof is addressed in the context of the RBA. Further, the effective number of exposures (N) should be defined as the actual number of underlying loans rather than the number of separate exposures in the pool. For example, in a securitization involving two mortgage-backed securities ("MBSs"), each with 1,000 underlying loans, N should be defined as 2,000; the ANPR would appear to calculate N as 2 for this example, which is clearly inconsistent with both the nature of the economic exposures and market convention.

The capital required for securitization liquidity facilities is significantly overstated. Liquidity facilities that can be drawn only in the event of a general market disruption are assigned a 20% credit conversion factor (CCF); all other facilities are assigned a 100% CCF. If a liquidity facility can be drawn only in the event of a general market disruption, the risk created is necessarily *liquidity* not *credit*; hence, by implication, the CCF should be close to or equal to zero. Similarly, liquidity facilities that can be drawn without a general market disruption may nonetheless represent significantly less credit risk than an outright exposure to the underlying assets; as such, these facilities should be assigned a CCF that is significantly less than 100%.

Similarly, if it is not possible to calculate the "K_{irb} capital amount" using either the top-down or bottom-up approach, a "Look-Through" approach is defined. Under this methodology, facilities maturing in one year or less are assigned a 50% CCF, while facilities with a maturity of longer than one year are assigned a 100% CCF. If the facilities do represent liquidity, rather than credit support, these factors overstate the risk exposures and the capital requirement.

We do not support the proposed rule that all 'non-retail' revolving securitizations be considered 100% on balance sheet, as if they had never been securitized. This approach is inconsistent with the ANPR's intent, as articulated on page 45932, which emphasizes that "...both the designation of positions as securitization exposures and the calculation of A-IRB capital requirements for securitization exposures would be guided by the economic substance of a given transaction, rather than by its legal form." There is no economic justification for creating such disincentives for non-retail, revolving securitization exposures, which legitimately transfer significant credit risk.

Securitizations of committed or non-retail facilities that utilize a controlled-amortization feature are arbitrarily assigned a CCF of 90 percent (the CCF is 100 percent if these facilities utilize a non-controlled amortization feature). We strongly disagree with this treatment. FleetBoston has successfully managed a revolving commercial-loan securitization program for 5 years, and we believe that there is no justification for the asymmetric treatment of securitized-retail and securitized-committed/non-retail revolving facilities. This treatment arbitrarily penalizes committed and non-retail revolving facilities, and is contrary to the ANPR's stated recognition criteria "...which are intended to ensure that securitization transactions transfer significant credit risk...".

The proposed treatment of securitization arbitrarily penalizes issuers relative to investors. While we favor the RBA for externally-rated exposures, we are opposed to using a different implementation standard for issuers and investors. Specifically, for an identical, rated position that is below K_{irb}, investors are permitted to apply the RBA; issuers are required to deduct these exposures from capital. We are mindful of concerns about the validity of ratings for non-traded positions, but would argue that the rating standards for non-offered notes are the same as those for offered notes; thus, their capital treatment should be the same.

Use of internal bank models for equity exposures is appropriate. In general, the approach for determining equity exposure capital seems reasonable. Use of a bank's own internal economic models, with regulator review and approval, is our preferred approach for any and all regulatory capital determinations. The materiality threshold that determines whether or not the advanced approach is required seems somewhat arbitrary, and we would like to better understand that rationale. Exclusion of nationally-legislated programs including CDCs and CEDEs, seems appropriate. We would add that fund investments should be treated as a single investment as the "look trough" approach would be impractical to implement. And finally, the definition of "a return directly linked to equity" needs clarification.

VAR-based methods for credit-risk capital of repos are appropriate and their use should be expanded. Use of a VAR approach for determining regulatory capital requirements for the counterparty credit risk inherent in repos and securities lending is an industry "best practice," and one we fully endorse. We would recommend that this approach be expanded to include all derivative transactions residing in the trading book. This would substantially improve upon the less-accurate, factor-based methodology employed in the current market-risk capital rules.

Capital benefits from use of credit derivatives seem unnecessarily conservative. The benefits of risk-mitigation are substantially reduced if the ANPR is adopted as written. We feel this treatment would not only be an incorrect portrayal of the economics but would also provide disincentives to banks to manage their credit risk with these important tools. First, there is the issue of "under recognition" of the benefits of "double-default." As with guarantees, because the risk of loss requires the occurrence of a double-default event, the risk of loss is materially smaller than provided for in the ANPR. We ask that this treatment be changed in the final rules.

Second, the impact of credit derivatives should be consistent with the A-IRB methodology applied to the underlying loan exposures. A potential and simple solution would be to run the underlying credit instrument of the credit derivative (or guarantee, for that matter) through the ANPR's corporate risk-weight function. This means that the risk reduction would be computed using the same PD, LGD, and EAD as the exposure being protected with the potential for a change in the maturity of the protection. The sign of the result, of course, would be negative. The maturity could be computed in the same manner as the exposure itself, eliminating any concern for amortizing versus bullet. Also, the maturity would be capped at the maturity of the exposure being hedged. The credit risk of the counterparty providing the protection would be determined separately as outlined in the ANPR.

Finally, FleetBoston makes use of credit derivatives (largely, credit default swaps) to hedge credit risks in its banking book. In our case, the derivatives are marked-to-market with the results flowing through earnings into equity (Tier 1 regulatory capital) while the hedged items remain on an accrual basis. To align the accounting results with the underlying economics, any gain or loss for credit derivatives used to hedge the credit portfolio should be removed from Tier 1 capital.

Conclusion

We commend the Agencies for their efforts to develop a more risk-sensitive regulatory capital framework and trust that they will continue to take into consideration the many positive suggestions offered by the industry as they craft the final version of the capital rules. While the proposal represents a significant improvement over the existing rules, we believe they do not go far enough. The banking industry will willingly work with regulators to arrive at a set of economically robust capital rules that will provide the appropriate economic incentives to develop a more safe, sound, and competitive banking system.

FleetBoston is prepared to provide further input to the Agencies' deliberations on this topic. Please contact Thomas Loeffler (617-434-7501 or thomas_h_loeffler@fleet.com) or William Schomburg (617-434-6158 or william_h_schomburg_iii@fleet.com) with further questions or comments.

Sincerely,

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