

January 19, 2005

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th Street & Constitution Avenue, NW
Washington, D.C. 20551
Docket No. OP-1215

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2004-48

Office of the Comptroller of the Currency
Attention: Docket No. 03-14
250 E Street, SW
Public Reference Room
Mail stop 1-5
Washington, D.C. 20219
Attention: Docket No. 04-22

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Re: Proposed Interagency Guidance on Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital

Ladies and Gentlemen:

Fifth Third Bancorp (Fifth Third) appreciates the opportunity to comment on the proposed guidance on internal ratings based approach for retail credit risk published in the Federal Register on October 27, 2004.

Fifth Third is a diversified financial services company headquartered in Cincinnati, Ohio. With over \$94 billion in assets, Fifth Third operates 17 affiliates with 1,088 full-service Banking Centers in Ohio, Kentucky, Indiana, Michigan, Illinois, Florida, Tennessee, West Virginia and Pennsylvania. Our primary businesses include commercial and retail banking, consumer finance, asset management, and payment processing.

Our comments address the proposed retail guidance for implementing the New Basel Capital Accord (Basel II) and the internal ratings-based (IRB) approach in the United States. This letter also accentuates Fifth Third's concerns with the underlying rules as presented by this proposed guidance as well as the proposed guidance on corporate credit risk issued in August 2003.

In principle Fifth Third supports the implementation of the IRB approach, but finds that the proposed guidance:

- is overly complex, potentially inflexible and will be very costly to implement. Many aspects of the rule appear to be cumbersome and mechanical in approach, which in some cases may result in excessive burden for small or immaterial risks.
- creates an unlevel playing field between IRB banks, non-IRB banks, and non-bank competitors.
- could potentially result in negative impacts on certain types of lending and leasing activities due to fixed risk-weights and capital floors which are not reflective of the underlying risks.
- will be much more difficult for the Agencies to supervise in a comprehensive and consistent manner. Small differences in supervisory approach or interpretation, from bank to bank or between Agencies, will likely lead to significant capital inequities putting some banks at a competitive disadvantage.

Specific Comments

Definition of Default

Fifth Third recommends that non-accrual be excluded from the definition of default for retail credit exposures. While non-accrual may be an important indicator of default for commercial exposures, its inclusion in the definition of default for retail exposures is inconsistent with the way that credit performance measures have been historically tracked. While most US banks apply a consistent charge-off policy in accordance with FFIEC guidance, non-accrual policies differ from bank to bank and across loan types. For example, under bank A's policy, delinquent secured term loans are not placed on non-accrual, rather loans will be charged-off within 30 days of becoming 120 days past due (in accordance with FFIEC guidance), while bank B's policy is to place all 90 day past due loans on non-accrual. This inconsistency in non-accrual policies will result in different capital requirements from bank to bank, even when risk profiles and credit performance of the underlying loans is the same. This discrepancy among capital requirements is because of the different relationships that each metric has on the output of the Basel II capital formula. LGD has a linear impact (10% increase in LGD results in a 10% increase in required capital), while PD has a non-linear impact to Basel II capital.

FFIEC guidance has standardized loss recognition among US banks. Until the Agencies, FASB and financial institutions agree on standardizing non-accrual policies, it should not be included in the calculation of regulatory capital.

Loss Given Default

Paragraph 127 suggests that banks must make adjustments to their long-run default weighted average LGDs to reflect loss severities for potential future periods of high

credit losses, which are outside the institution's historical experience. All such adjustments and/or add-ons are, by their nature, subjective and prone to inherent bias. As a core credit risk performance metric, LGD should be an empirically based measure of actual experience. Any limitation in the amount high credit loss periods included in an institution's historical performance data should be addressed through stress testing and in the assessment of capital adequacy and capital cushion under Pillar II.

Correlation Assumption for Other Retail Exposures

The curvilinear correlation function required for Other Retail Exposures results in a dramatically higher capital charge as compared to Qualifying Revolving Exposures with the same level of risk. This capital disparity is amplified for low PD exposures. For example, a prime auto loan can require three or even four times the regulatory capital as a credit card loan made to the same borrower (same PD, LGD and EAD). There appears to be little or no empirical evidence supporting this differential in capital requirements. Our own cursory analysis on fifteen years of industry loss data indicates that the historical volatility of loss for "Other" consumer loans is comparable to that of credit card loans. Establishing a regulatory capital penalty on banking institutions that make low risk term loans to consumers (i.e., prime auto loans and student loans) is not empirically supportable, is bad public policy and, will undoubtedly result in changes in lending practices and the availability of certain types of credit.

Lease Residuals

We strongly urge the Agencies to reconsider the arbitrary assignment of 100% risk-weight on lease residuals, indicated in paragraph 152. Such fixed capital requirements are wholly inconsistent with the spirit and intent of Basel II. The 100% risk weighting will require banks to hold significantly higher capital for leases as compared to loans having the same aggregate level of risk. Further, the proposed rule ignores the use of risk mitigants such as residual value insurance, residual value reserves and forward sale agreements that many institutions employ. A fixed capital requirement will put regulated banking institutions at a complete disadvantage to non-regulated leasing industry participants. Fifth Third strongly recommends that the Agencies adopt a risk-based economic capital approach for both retail and commercial lease residuals. Although residual value losses do occur, our historical experience shows that in vast majority of cases, residual realization results in both an accounting and economic gain. Like most institutions with significant leasing operations, Fifth Third maintains historical data on valuation adjustments and residual value losses. Further, industry data on residual values is both deep and widely available. Secondary markets are well-established and historical price guides and used asset indexes are published for all of the predominant leasing categories. It is important to ensure that with the adoption of Basel II, regulatory capital requirements reflect the true, economic risks.

Validation

Banks conducting continuous validation procedures on risk segmentation and quantification, which are both robust and auditable, should be able to avoid mandated annual validation reviews. Automation of validation and recalibration procedures can greatly enhance the timeliness and accuracy of both segmentation and quantification.

Automation can also increase the level of independence in the validation process. Continuous validation should be an allowable substitute for annual validation exercises.

Calculation of Required Capital

The formula presented in paragraph 15 is inconsistent with the formula for retail credit exposures published by the Basel Committee in June 2004 and derives a significantly lower capital requirement for a given set of PDs and LGDs. Application of the Agency's formula will further exacerbate a non-level playing field between IRB and non-IRB institutions.

Cost of Implementation

As with most large banking organizations, Fifth Third has already made significant investments in anticipation of Basel II. We anticipate that implementation of IRB processes will require substantial additional investments in resources, staffing and capital expenditure. The proposed retail IRB guidance, along with the previously issued corporate guidance, will necessitate the development or acquisition of new information systems and enhanced data warehouse capabilities. Based on industry surveys, we expected that an additional \$50 million investment will be required over the next several years to implement the requirements of the proposal. This does not include the additional on-going expense to staff and maintain these systems after implementation is completed. While this investment will derive improvements in risk management and portfolio management, it represents a significant expense burden on the institution.

We trust that our comments will provide you with the information necessary to facilitate refinements to the proposed guidance. Ultimately, it is our desire to see the new capital rules become an effective and efficient arrangement to ensure banks are adequately capitalized while allowing banks to benefit from the expected lower capital levels that will result from improvements in risk measurement and a more risk sensitive regulatory capital framework.

Should you want to discuss our comments in greater detail, please contact Bernd Klink at (513) 534-7886 or David Kerns at (513) 534-1896.

Sincerely,

/s/ Malcolm Griggs

Malcolm Griggs
Chief Risk Officer
EVP, Enterprise Risk Management
Fifth Third Bancorp