David Schraa
Director
Regulatory Affairs Department

Institute of International Finance, Inc.

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Office of the Comptroller of the Currency 250 E Street, S.W. Mail Stop 1-5 Washington, D.C. 20219 ATTN: Docket No. OCC-2007-0004	Robert E. Feldman, Executive Secretary Attention: Comments Federal Deposit Insurance Corporation 550 17th Street, N.W. Washington, D.C. 20429 Basel II Supervisory Guidance
Ms. Jennifer J. Johnson, Secretary Board of Governors of the Federal Reserve System 20th Street and Constitution Avenue, N.W. Washington, D.C., 20551 ATTN: Docket No. OP-1277	Regulation Comments Chief Counsel's Office Office of Thrift Supervision 1700 G Street, N.W. Washington, D.C. 20552 ATTN: Docket No. 2007-06

Re: Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, Operational Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process (Pillar 2); 72 *Federal Register* 9084, February 28, 2007.

Ladies and Gentlemen:

The Institute of International Finance (IIF) appreciates the opportunity to comment on the Basel II Advanced Internal Ratings-Based Approach supervisory guidance proposed by the Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision (collectively, "the Agencies") on February 28, 2007. With more than 360 members in over 60 countries, the IIF represents a wide spectrum of internationally active financial institutions, including the major US banks as well as the leading banks across the world.

The IIF is commenting on the proposed Guidance given its significance and potential effects, not only for US banks, but for a number of international banks with significant operations in the US. The US Agencies' proposed guidance will undoubtedly have implications for the entire global financial-services sector, not only because of the sheer size of the assets covered by the banking institutions to which the proposed rules will apply to but also because of the influence that the US guidance will have over the policy-setting process to be undertaken by other jurisdictions, in particular in emerging markets.

Our main objective, as repeatedly stated during the years of consultation with the Basel Committee on Banking Supervision (BCBS) that led to the Basel II international framework, is to promote the development of a consistent regulatory framework across jurisdictions. We believe that regulatory consistency is vitally important not only for the industry and, in particular, internationally active groups, but also for national, regional and international regulators. The benefits of consistent regulation will be reflected in both more efficient banking operations and in smoother and more effective supervision of cross-border banks.

While we recognize that this response falls outside the period for comment, we judged it important to convey to the Agencies some salient concerns with respect to the proposed Supervisory Guidance. The following comments, adduced at a high level of generality, reflect feedback the IIF has received from member firms.

Key Issues

The IIF broadly supports efforts to modernize the risk-based capital regime and create a risk-sensitive framework under which firms are encouraged to improve their internal risk management practices.

In pursuing this objective, the IIF strongly encourages the Agencies to avoid diverging from the international framework as defined by the BCBS in the November 2005 document *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel II or the international framework) when drawing up rules for banks operating in the US. The IIF has already commented on several specific requirements in the Agencies' recent Basel II Notice of Proposed Rulemaking (NPR) that deviate significantly from the international framework.[1] The IIF is concerned that several of the proposed supervisory standards may reinforce these NPR proposals, which could have detrimental consequences for the US banking industry and internationally active banks.

1. *Prescriptiveness*

The proposed Guidance contains 140 standards, most of which though expressed as guidance are in effect prescriptive in requiring banks to comply de facto with the standard as written. Instead of stating standards for how their risk management models, "best practice" standards and internal procedures will be judged by the Agencies, the Guidance requires banks to set policies to justify virtually every aspect of their internal risk management models. The level of detail demanded by the Guidance would represent a significant burden to the banking industry by requiring detailed procedures and documentation of steps in the implementation process. Not only would this be cumbersome bureaucratically, but it would also deter firms' continued advancement and modernization of internal risk management, in particular if efforts that could be devoted to risk management are diverted to purely compliance-driven procedures. Finally, it may be extra burdensome for internationally active banks which may have to make similar but not identical documentation available to other national regulators (given the departure of the US rules from the internationally agreed framework).

2. *Proposals should reinforce risk-sensitivity*

Some of the proposed standards are excessively conservative and may actually undermine the risk sensitivity of banks' IRB models. The Guidance appropriately provides that the ratings banks use must be accurate and reliably differentiate degrees of credit risk, but many of the more specific

[1] Sent on March 26, 2007, our comment letter was the joint effort of the IIF, the International Swaps and Derivatives Association (ISDA), and the London Investment Banking Association (LIBA).

requirements require a level of conservatism in parameter estimation that could lead to higher regulatory capital requirements being held against low-risk businesses than against higher-risk businesses, or otherwise interfere with or unduly complicate the risk management systems in which banks have made significant investments. The Guidance's almost exclusive reliance on quantitative measurement and the lack of sufficient reliance on banks' own standards of credit risk management depart from the goal of aligning regulatory capital with good internal risk management and may, in certain cases, interfere with management decision-making.

In addition, the proposed standards require banks to use the NPR's definition of default, which diverges from the international framework in important ways. The NPR sets a 5% threshold for materiality of credit-related loss on sale of an exposure, under which all obligations must be considered in default if they reach that target. As a result of this requirement, which increases the risk of misclassification by substituting a fixed percentage for banks' own judgments, internationally active banks operating in the US will face greater compliance costs and increasingly higher Pillar 1 capital requirements. As advocated in our NPR comment letter, we encourage the Agencies to consider adopting the language of the international framework in this area.

3. *Boards of Directors Responsibilities*

The IIF supports the fact that boards of directors play a significant role in Basel II systems. However, several of the proposed standards envision an intensive level of board involvement in the meticulous oversight of credit and operational risk. Without adequate distinction between policies and procedures, the boundaries of responsibility between the board and management are unclear, something that will detract from adequate risk management. In our view, the guidance should make clear that the board of directors ought to be able to delegate authority for the oversight of implementation and evaluation of the internal systems to senior management, in accordance with the board's role in the oversight of other systemic risks.

Conclusion

The IIF is committed to the adoption of the advanced approaches in the US through a consistent application of the Basel II international framework. We remain concerned, however, that the proposed Supervisory Guidance would impose unnecessary regulatory burden on financial institutions while inadvertently restraining the advancement of "best practices" in internal risk management. A less prescriptive, more principles-based approach would, we believe, provide greater risk sensitivity and prudential flexibility to financial institutions operating in the US.

We stand ready to respond to any requirement for further elaboration or clarifications in our comments and reiterate our disposition to collaborate with the Agencies in the promotion of a risk-sensitive and efficient revised regulatory capital framework.

Sincerely,