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March 23, 2007

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Docket No. 06-09
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RIN 1557-AC91

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Regulation Comments
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Attn: No. 2006-33
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RIN 1550-AB56

Re: Joint Notice of Proposed Rulemaking (NPR) Implementing New Risk-Based Capital Framework in the United States

Introduction

JPMorgan Chase & Co. is pleased to provide comments on the Notice of Proposed Rulemaking (NPR) implementing a new risk-based capital framework in the United States, also known as Basel II, as published in the Federal Register on September 25, 2006. As a large, internationally active banking organization, JPMorgan Chase & Co. is a "core bank"[1] that will be required under this NPR to implement the U.S. version of the advanced approaches[2] described in the new Basel II Capital Accord[3] (the Accord) rather than continue under the existing risk-based capital rules (Basel I[4]).

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[1] "Core bank" refers to any banking organization with either consolidated total assets of $250 billion or more or on-balance sheet foreign exposure of $10 billion or more that is required to adopt the proposed rule.

[2] "Advanced approaches" refer to the Advanced Internal Ratings Based (A-IRB) and Advanced Measurement Approach (AMA) for credit and operational risk, respectively.

[3] "International Convergence of Capital Measurements and Capital Standards, A Revised Framework." *Basel Committee on Banking Supervision*, June 2004, November 2005 and June 2006.

[4] "Basel I" regulations refer to the current risk-based capital regulations in the U.S., which represent the U.S. implementation of the original 1988 Basel Accord and subsequent modifications to date as published by the U.S. agencies.

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We believe very substantial progress has been made in developing a new, more risk-sensitive capital framework for large, internationally active banking organizations since the Advance Notice of Proposed Rulemaking (ANPR) was published in August 2003. Having been actively involved in the Basel II process since it began under the Basel Committee on Banking Supervision (Basel Committee), we greatly appreciate this opportunity to comment as part of a continuing, constructive dialogue with the agencies.[5]

We are including as appendices to this letter separate comments on Basel II information collections activities and the Basel 1A[6] proposal. We also have previously submitted comment letters on the Market Risk NPR and associated reporting requirements. Although each of these comment letters is a stand-alone document, we request the agencies incorporate by way of reference our other comment letters as part of our response to the Basel II NPR.

Our comment letter is structured as follows:

I. Executive Summary
II. Support for a Risk Sensitive Capital Framework
III. Constraints on the Overall Level of Capital
IV. Capital Requirements for Credit Risk
V. Capital Requirements for Operational Risk
VI. Responses to Specific Questions in the NPR

Appendix A – Downturn LGD and the NPR
Appendix B – Comments on the Basel II Reporting Requirements
Appendix C – Comments on the Basel 1A NPR

I. Executive Summary

JPMorgan Chase & Co. has fully and consistently supported the goals of Basel II capital adequacy reform: to create a more risk-sensitive capital framework and provide incentives for banking organizations to improve their risk management and measurement practices. We have a substantial investment program in place to implement Basel II.

While we continue to support the direction of Basel II, we are principally concerned with several specific requirements in the NPR that depart significantly from the international Basel II Accord. These departures in turn impose constraints and calculations that reduce the risk sensitivity of capital calculations, less effectively promote the objective of improved risk management or unnecessarily add to costs. The net impact of these

[5] The term "agencies" refers collectively to the Federal Reserve Board, FDIC, OCC and OTS, as defined in the NPR. Unless expressly defined, other terms of art employed in this letter are generally consistent with the NPR definitions.

[6] "Basel 1A" refers to proposed modifications to the Basel I regulations as published in the *Federal Register*, Dec. 26, 2006.

incremental requirements is to place firms subject to this NPR at a disadvantage relative to competitors. Below is a summary of our principal concerns.

Constraints on the Overall Level of Capital

- Allowable Declines in Capital We are concerned that the agencies intend to revise this rule if aggregate minimum capital requirements of U.S. banks[7] subject to Basel II decline by 10% or more from current Basel I levels. We oppose reliance on Basel I as a baseline because it is not risk sensitive. Also, since the limit is not institution-specific, it can be triggered by a large decline at a small number of banks that will impact all banks. This requirement is also unnecessary given existing supervisory authority to maintain adequate capital at individual banks. U.S. banks will be at a competitive disadvantage due to future uncertainty around the possibility of further rule changes that might apply only in this country. The agencies should instead consider any need for further changes to the final rule by evaluating outcomes at individual banks and by consultation with the Basel Committee.

- Transitional Floor Periods The capital requirements during the first two transitional floor periods are materially higher than those imposed in other jurisdictions, and the agencies have added a third floor period. Separate written approval is required to end each transition period so each period can therefore last longer than one year. None of these additional requirements is in the Accord. Based on expected timetables, major international competitors outside the U.S. will be subject to materially lower floors in 2009 and no floors beyond 2009 while the U.S. floors will extend to 2011 and possibly beyond. We strongly request the agencies conform the transition rules to the Accord.

- Leverage Ratio The U.S. is virtually alone among jurisdictions in imposing a leverage ratio. Moreover, U.S. investment banks are not subject to such a requirement. As a percent of nominal assets, the leverage ratio by definition does not adequately capture the risk of on- or off-balance sheet assets and is a misleading indicator of a bank's capital adequacy. Because of this lack of risk sensitivity, continued use of the leverage ratio is in conflict with the fundamental objective of Basel II whereby minimum regulatory capital requirements are better aligned with risk. Should the leverage ratio become binding, the result will be that affected banks will either hold undue amounts of excess capital, conferring a capital advantage to foreign banks and investment banks, or will shift to riskier assets to provide an adequate return. We urge the agencies to review the appropriateness of the leverage ratio as presently defined and consider modifications to its composition and required level. We suggest a review take place within an appropriate time frame, for example, prior to the end of the Basel II transition period.

[7] The NPR uses the term "bank" to include banks, savings associations, and bank holding companies (BHCs). We also adopt this usage for simplicity.

- Lack of Alternative Approaches The agencies permit only one choice among the Basel II approaches. Approximately ten of the largest or most internationally active banks are restricted to the advanced internal ratings-based approach. Other banks remain on the current or modified Basel I capital framework with the possibility that a small number of them can "opt in" to the advanced approach. We request that the agencies provide all banks irrespective of size with the full range of Basel II approaches. Institutions will then be able to choose an approach that best balances risk sensitivity, implementation costs and competitive issues.

Capital Calculations for Credit Risk

- Definition of Default We oppose the change to the definition of default under which all obligations to a wholesale borrower must be considered in default if the sale or transfer of any exposure to the borrower resulted in a credit-related loss of 5% or more of initial carrying value. We request that the agencies return to the language of the Accord, which requires recognition of default in the event of a material credit-related loss based on a bank's own judgment. Imposition of a fixed percentage to determine materiality will create a greater risk of misclassification, substitute for a more fully fact-based determination of the obligor's likelihood to pay and impose additional regulatory burdens on those international firms operating in multiple jurisdictions because they will be required to maintain two definitions and two sets of capital calculations.

- Downturn Loss Given Default (LGD) We oppose the proposed supervisory mapping function for downturn LGD because it will systemically overestimate the impact of economic downturns on exposures with low to moderate LGDs. To the extent that banks can demonstrate sufficient conservatism in their estimation processes such that their estimate incorporates downturn conditions, the need to apply a markup via a supervisory formula to obtain a downturn LGD is obviated. While we recognize the agencies created this function as a fallback, we are concerned that it may hinder the approval of internal LGD estimates by becoming a de facto requirement in the absence of copious observation points to support a bank's LGD assumptions even if those assumptions are arrived at with a clear rationale and conservative factors. We also oppose the imposition of supervisory LGDs in place of internal estimates for an entire exposure category where a bank can produce credible and reliable internal estimates for most but not all of the exposures.[8] Maintaining multiple LGDs (expected, downturn and supervisory) is further problematic because this creates a gap to internal practice. The final rule can reflect the objective that LGD estimates are reasonable and appropriately conservative for a range of economic conditions without these additional requirements.

[8] The NPR defines five broad credit exposure subcategories: residential mortgage, retail revolving, other retail, high volatility commercial real estate (HVCRE) and wholesale ex HVCRE.

- Use of Internal Assessment Approach The Basel II securitization hierarchy and the qualification criteria that support the Internal Assessment Approach (IAA)[9] have restricted the use of this treatment to a set of transactions that meet the criteria described in Section 42 of the NPR. Under this rule, the only transactions eligible for IAA treatment would be asset-backed commercial paper conduits supported by traditional credit assets[10] with publicly available rating criteria from the rating agencies. Ineligible transactions would automatically fall to the Supervisory Formula and may result in a capital deduction. We recommend that if such transactions meet all other IAA criteria then eligibility for IAA should be expanded to include them.

- Recognition of Credit Hedges While the proposed rule is largely consistent with the Accord in the treatment of credit hedging, we encourage the agencies to reconsider the proposed treatment together with the Basel Committee. Improved capital treatment of double default, maturity mismatch and restructuring haircuts will provide more appropriate incentives for risk mitigation through the use of credit hedges.

- Hedge Fund Treatment The treatment of hedge fund investments and investment funds with material liabilities is not clearly specified in the proposed rule. We request that these be subject to the equity rules, except for exposures in the trading account which should remain subject to market risk rules. We oppose an alternative interpretation of such investments as securitization exposures requiring a capital deduction, which in our view creates an overly broad definition that could be similarly extended to other exposure categories.

- Capital for Small to Medium Size Enterprises The NPR modifies the capital formula for lending to small to medium size enterprises, resulting in a higher capital charge relative to the Accord. We request use of the Accord formula which recognizes the lower risk of this activity.

Capital Calculations for Operational Risk

- Capital for Fixed Assets The regulatory proposal to compute capital for fixed assets is flawed. The proposal creates a capital charge for "risk-weighted asset amounts for assets that are not included in an exposure category" and further suggests that additional capital may be required as the carrying value of such assets on the balance sheet can be substantially less than market or replacement value. We strongly believe that such a capital charge is unnecessary and inappropriate. The Basel II definition of operational risk capital includes a category for Damage to Physical Assets. Accordingly, continuation of the Basel I

[9] The IAA was developed specifically to be used to calculate the RWA associated with liquidity facilities and credit enhancement that support Asset Backed Commercial Paper (ABCP) Conduit Programs. The internal obligor grade is mapped to an external rating which is used to determine the risk weight based on a table supplied by the regulators.

[10] This would exclude support from non-traditional sources, such as TV and film royalties.

Fixed Assets charge is duplicative. Moreover, suggesting that additional capital may be required as the market value of these assets may exceed the book value is asymmetrical because no credit is given for the implied capital gains. Such logic begs the question, if assets were over-valued on the balance sheet would that free up regulatory capital?

- Disclosure We are strongly opposed to the public disclosures as outlined in the present proposal. The detailed information related to the component breakdown of operational risk capital will be confusing at best and most probably misleading in the public domain. This is particularly true given that there are no common definitions, methodologies or overall standards for the calculation of these data items and such data will not be comparable across individual banks. Putting such information into the public domain for a small number of banks serves no beneficial purpose at this time.

- Reporting Requirements We are also strongly opposed to the proposed reporting requirements identified as confidential. Requesting such information quarterly is contrary to the principles outlined in the Accord and the consultative documents supporting the NPR. The effort is nearly tantamount to making the Quantitative Impact Studies for operational risk a quarterly exercise. Moreover, this detailed profile of loss information represents only a portion of the data used to compute operational risk capital. A program of periodic and specialized data requests (e.g. QIS initiatives) along with the annual reviews and examinations currently underway is a much preferred and entirely more efficacious approach to supervisory review of loss data and capital calibration.

In the remainder of our letter we provide more detail on these concerns and also comment on a number of other issues, including other inconsistencies with the Accord. As indicated above, several NPR rules require substantial modification or elimination if the new capital framework is to produce an effective risk-sensitive capital regime. It is our intent to provide constructive proposals for change that would maintain the safety and soundness of the banking system and would not result in undue delays in the rulemaking process.

II. Support for a Risk Sensitive Capital Framework

We continue to strongly support the Basel II approach to capital adequacy. The multi-pillar approach, which addresses minimum capital requirements (Pillar 1), supervisory review of capital adequacy (Pillar 2) and market discipline (Pillar 3), constitutes a solid framework whereby the agencies will be better equipped to address safety and soundness issues in today's complex financial markets.

Under Pillar 1, the new risk-based capital framework is designed to establish minimum capital requirements with far more granularity and risk sensitivity than the current capital regime, reducing potential for inefficient use of capital and regulatory arbitrage. By permitting banks to use their own internal risk inputs under the Advanced Internal

Ratings Based (A-IRB) Approach for credit risk and Advanced Measurement Approach (AMA) for operational risk, the resulting regulatory risk measurement system is an important step toward aligning more closely with modern risk management and measurement practices.

This new approach addresses the major shortcomings of the current capital regime. Under the existing Basel I approach, risk weights generally do not vary with risk, empirical risk measurement data are not employed and consequently neither the actual degree of risk nor the impact of risk management practices are adequately reflected in the calculation of current capital requirements.

While this NPR represents a significant step toward a more risk sensitive framework, some aspects of the proposals are not fully consistent with or run counter to this objective. We discuss our key concerns in the following sections.

III. Constraints on the Overall Level of Capital

We fully appreciate the importance of setting appropriate minimum capital requirements for banking organizations given their important role in the financial system and the economy. Well-designed minimum capital requirements are a vital component of the capital adequacy framework and, together with the supervisory review and market discipline, promote safety and soundness, help protect insurance funds and provide a basis for timely supervisory intervention when necessary.

However, in our view, minimum capital requirements under Pillar 1 should not become binding constraints for well-run banking organizations operating under normal business conditions. Under these normal circumstances, actual capital would exceed minimum capital requirements. Numerous other considerations enter into capital decisions, such as debt rating, capital allocation, business strategy and future outlook, resulting in a buffer between actual and minimum capital levels. If minimum capital requirements were unduly constrained, the loss of managerial flexibility would result in sub-optimal capital decisions.

The following overall constraints on minimum capital requirements in the NPR are the most significant among our concerns:

A. Recalibration if Aggregate Capital Declines 10%
B. Transitional Floor Periods
C. Leverage Ratio
D. Lack of Availability of Alternative Basel II Approaches

Each of these constraints contributes to the creation or retention of non-risk sensitive floors. When binding, these constraints override all detailed risk-sensitive capital calculations, thus disconnecting the computed Pillar 1 capital for the component parts from aggregate capital requirements.

These additional constraints and transition period modifications are not found in the Accord or its implementation in other jurisdictions, but only in the U.S. NPR. Consequently, they will create competitive inequities for organizations subject to the NPR.

A. Recalibration if Aggregate Capital Declines 10%

As stated in the NPR, *"the agencies will view a 10 percent or greater decline in aggregate minimum required risk-based capital (without reference to the effects of the transitional floors...), compared to minimum required risk-based capital as determined under the existing rules, as a material reduction warranting modifications to the supervisory risk functions or other aspects of this framework.*
The agencies are, in short, identifying a numerical benchmark for evaluating and responding to capital outcomes during the parallel run and transitional floor periods that do not comport with the overall capital objectives outlined in the ANPR. At the end of the transitional floor periods, the agencies would reevaluate the consistency of the framework, as (possibly) revised during the transitional floor periods, with the capital goals outlined in the ANPR and with the maintenance of broad competitive parity between banks adopting the framework and other banks, and would be prepared to make further changes to the framework if warranted."[11]

We are concerned that the agencies have identified a single numerical benchmark based on comparison to the Basel I capital standard as an overriding factor in determining whether major revisions to the NPR version of the framework are needed. Given that Basel I is no longer an appropriate yardstick for measuring capital requirements relative to risk, we oppose reliance on this metric in determining the need for changes to the Basel II framework.

The following example illustrates the difficulty in reliance on aggregate measures across institutions. Consider a system with two banks, an undercapitalized, very high risk bank and an overcapitalized, very low risk bank. The aggregate percentage amount of Basel I capital in the system (e.g. 90%) conveys no information about capital adequacy at the institutional level, which is critical to safety and soundness concerns. Even a higher aggregate capital requirement, say 110%, could leave both banks with inappropriate capital levels and even move them in the wrong direction in the absence of better information on risk and risk management to inform supervision. This illustrates that the benefits and direction of the new framework are at risk if the agencies place undue emphasis on aggregate capital rather than outcomes at individual banking organizations in evaluating the performance of the Basel II framework.

The 10% rule may be impractical or even impossible to implement. Whether the 10% threshold is exceeded can depend on the timing decisions of a few mandatory or opt-in institutions (particularly institutions with predominantly low credit risk assets on their balance sheets). Measurement of the percent decline in capital could be computed in each time period only for those banks that had already implemented Basel II. At any

[11] *Federal Register*, Vol. 71, No. 185, September 25, 2006: p. 55839.

given time, the set of qualified Basel II banks will vary, and the results of the aggregate capital calculation will not be comparable. Given the possibility of extended transition periods beyond three years (see later comments in Section B), there are a variety of scenarios where a 10% decline is inappropriately triggered based only on the sequencing and timing of each institution's start date. One example would be if one or two smaller institutions qualified in 2009 with an aggregate decline over 10%, followed by several larger institutions in 2010 with an aggregate decline less than 10%. Timing and opt-in decisions should not be driven by this aggregate capital consideration, nor should banks be impacted by timing and opt-in events external to them.

Since risk-based capital under Basel II rules varies with the credit environment, the 10% threshold could also be triggered by a general improvement in credit quality. In this instance, by tying a formal recalibration requirement to aggregate Basel I capital levels, the U.S. framework is being designed not to be risk-sensitive.

As an alternative, we urge the U.S. agencies to continue to work with the Basel Committee to review the effectiveness of the Accord and make appropriate adjustments in consultation with the industry. A recalibration trigger applied unilaterally by one jurisdiction is not a desirable addition to this existing process which promotes international harmonization.

In our view, this requirement is also unnecessary given that there is already a process in place through the Basel Committee to review the scaling factor used for capital calibration. This process serves to maintain adequate system-wide capital levels across jurisdictions. Prior to the publication of this NPR, the Basel Committee reaffirmed a scaling factor of 1.06 based on the results of the most recent international quantitative impact study, QIS5. The results of QIS5 indicated that minimum required capital for large internationally active banks adopting the advanced approach would have decreased by 7.1% relative to the current Accord. The Committee noted in its executive summary that *"no adjustment of the scaling factor of 1.06 ... would be warranted at this time."*[12]

Given that the agencies have other tools at their disposal to ensure adequate capital at the institutional level (i.e. under reservation of authority clauses and the Pillar 2 process, as well as the Basel Committee calibration mechanism), we see no justification for this additional U.S. requirement and request that it be removed. We note that this requirement appeared in the preamble but not in the actual text of the rule, but nevertheless we request that the agencies do not rely on a numerical benchmark for aggregate capital as a trigger mechanism for changes to the U.S. implementation of the Accord.

B. Transitional Floor Periods

When compared to the Accord timetable, banking organizations subject to the NPR rules begin the parallel run one year later that those subject to the Accord. Following completion of the one year parallel qualification period, the NPR requires a minimum of

[12] "Results of the fifth quantitative impact study (QIS5)." *Basel Committee*, June 16, 2006.

three separate transition periods with a minimum duration of one year each and possibly longer, instead of two periods of one year each per the Accord. Unlike the Accord, the NPR requires separate written supervisory approvals to begin and end each of the three transition periods. As a result, the NPR version of the transition period ends two years or possibly more after the comparable end-date set in the Accord.

Beyond differences in duration, the NPR sets higher floors on capital requirements throughout the transition period. The floor percentages (95%, 90% and 85% in each of the three periods, respectively, are substantially higher than the Accord (90% and 80% in each of the two periods, respectively).

In addition, the NPR applies a different floor calculation methodology. Under the NPR, the floor calculation[13] is based on Basel I risk weighted assets (RWA), whereas RWA per the Accord floor[14] is the sum of Basel I RWA less 12.5 times Basel I amounts of general provisions included in Tier 2 capital. Because the NPR method lacks this adjustment, it creates a significantly higher RWA floor.

The NPR method effectively places a RWA floor that includes both expected loss (EL) and unexpected loss (UL) against a UL-only Basel II RWA. This is conceptually inconsistent with the UL-only approach agreed to by the Basel Committee.

The combination of a higher percentage times a higher calculated amount over a delayed and more prolonged period compounds the punitive impact of these departures from the Accord. We strongly oppose these rule differences which will create competitive inequities for banking organizations subject to NPR rules throughout the protracted U.S. version of the transition period.

We request that the U.S. transition period requirements conform to the Accord, with two one-year transition periods with 90% and 80% floor percentages, respectively. We also request that the agencies drop the separate supervisory approval requirement to move to the next transition period, in order to avoid increasing the delay in U.S. implementation at the back end of the transition period. Finally, we oppose the use of a different method to calculating the floor capital requirements, which should instead be identical to the method given in the Accord.

C. Leverage Ratio

In the NPR, the OTS notes *"that some institutions with low credit risk portfolios face an existing competitive disadvantage because they are bound by a non-risk based capital requirement—the leverage ratio. Thus, the agencies regulate a class of institutions that currently receive fewer capital benefits from risk-based capital rules because they are bound by the risk-insensitive leverage ratio."*[15]

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[13] Per Section 21(e) of the NPR, *Federal Register*, Vol. 71 No. 185: p. 55922.
[14] Par. 45-47 of the Accord.
[15] *Federal Register*, Vol. 71, No. 185, September 25, 2006: p. 55910.

We agree that the leverage ratio is not a risk sensitive measure and creates competitive inequities. As noted, this ratio is most likely to be binding for institutions with a substantial proportion of low credit risk assets on balance sheet. Not only does this create an inappropriate incentive for institutions to shift toward higher risk or off-balance sheet assets, but from a wider economic perspective, this discourages institutions from offering beneficial financial services that result in the accumulation of low credit risk assets on their balance sheets.

The NPR *states "QIS–4 results also suggested that Tier 1 risk-based capital requirements under a Basel II-based framework would be lower for many banks than they are under the general risk-based capital rules, in part reflecting the move to a UL-only risk-based capital requirement."*[16] The agencies noted that as a result "the existing Tier 1 leverage ratio requirement could be a more important constraint than it is currently."

A significant driver of lower Tier 1 requirements observed in QIS4 is the 2003 decision by the Basel Committee, supported by the agencies, to separate the unexpected loss (UL) and expected loss (EL) components under the new framework. As stated at that time: *"The Committee now believes that a separation of the treatment of unexpected and expected losses within the IRB approach would lead to a superior and more consistent framework. Under this modified approach, the measurement of risk-weighted assets (that is, the IRB capital requirement) would be based solely on the unexpected loss portion of the IRB calculations. Accordingly, certain offsets within the IRB framework, in particular future margin income, would no longer be necessary."*[17]

Long term retention of the leverage ratio in its current form is inconsistent with the new UL-only framework. Other mechanisms have been incorporated into the Accord to compensate for the reduction in Tier 1 requirements due to EL-UL separation. These include the elimination of ALLL from Tier 2 capital except for a limited excess over expected credit losses and the non-recognition of future margin income. Given these changes, the incremental impact of the leverage ratio becomes unduly punitive.

The U.S. is virtually alone among jurisdictions in imposing a leverage ratio. Moreover, U.S. investment banks are not subject to such a requirement. Firms that are not subject to a leverage ratio can better allocate capital and balance their portfolio mix based on risk management and return on capital considerations. We believe that, in the long run, permanent retention of the leverage ratio in its present form will be harmful to the competitiveness of banking organizations subject to U.S. capital regulations. We urge the agencies to review the appropriateness of the leverage ratio as presently defined and consider modifications to its composition and required level. We suggest a review take place within an appropriate time frame, for example, prior to the end of the Basel II transition period.

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[16] "Basel II: Significant Progress on Major Issues." *Basel Committee*, October 11. 2003 press release.
[17] "Basel II: Significant Progress on Major Issues." *Basel Committee*, October 11. 2003 press release.

D. Lack of Availability of Alternative Basel II Approaches

We believe there is a need for all U.S. banking organizations to be able to choose from the entire set of alternatives available under the Accord. Under the Accord, banking organizations of any size may adopt alternative methodologies, including the Standardized approach. Outside the U.S., those jurisdictions adopting the Accord generally permit all approaches.

Providing banks with the full range of approaches to risk-based capital has these important benefits:

- All banks are on a level playing field, thus eliminating competitive inequities both domestically and internationally;
- All approaches were designed by the Basel Committee to ensure appropriate minimum regulatory capital requirements; and
- Banks, irrespective of size, can make their own cost/benefit assessments of the risk sensitivity of each option.

In the NPR, the agencies state that it is *"crucial to promote continual advancement of the risk measurement and management practices of large and internationally active banks"*[18] and, as a result, chose to implement only the advanced approaches. We emphasize that we support these objectives, as expressed by Basel Committee at the outset of the Basel II process and again by the U.S. agencies in this NPR. Support for the availability of alternative approaches should not be misinterpreted as a departure from our desire to retain the advanced approaches, consistent with the industry's continual efforts to achieve the highest standards of risk management practice.

Offering a choice among approaches to all banks will provide additional benefits of improved risk sensitivity to the system as well as to the individual banks. For some institutions, use of Standardized or other less advanced approaches may be an end state rather than a transition to the most advanced approaches. Were the U.S. agencies to offer the full menu of options and not address our concerns on the advanced approaches, however, we believe the result would be sub-optimal.

The Accord provides both advanced and simpler approaches to permit banks to determine their Pillar I capital requirement approach with due consideration of costs and benefits of each option. The approaches were designed and calibrated so that capital levels varied inversely with level of sophistication applied. The Standardized approach in particular offers a meaningful improvement in risk sensitivity over the existing Basel I approach due to the inclusion of operational risk requirements combined with improved credit risk weights. Banks will opt for the Standardized approach if it makes more sense for them to do so based on risk sensitivity, implementation cost and competitive considerations. Since alternative approaches were designed by the Basel Committee to be durable, there are no provisions in the Accord setting a time frame to discontinue their use. The Basel

[18] *Federal Register*, Vol. 71. No. 185, September 25, 2006: p. 55840.

Committee's rationale for alternative approaches was not intended to mandate a transition to a more advanced approach.

We believe that the agencies can adopt the Standardized and other approaches without departing significantly from the text of the Accord, which has been developed over several years with international input from supervisors and industry. Inconsistencies between the U.S. rule and the Accord for the Standardized approach would raise concerns similar to those raised for the advanced approach.

One of the purposes of QIS5 was to evaluate the incentive for banks to choose between approaches. According to the Basel Committee, *"In order to analyse the incentives for banks to move to the more advanced approaches, the capital requirements for banks providing data on at least two different approaches were compared. This analysis shows that capital requirements provide an incentive for banks on average to move to the more advanced approaches."*[19]

We are confident that banking organizations, when permitted to evaluate the trade-offs between approaches, will make sound individual decisions, subject to supervisory oversight, contributing to improved safety and soundness and greater capital efficiency for the system as a whole. In making its decision, each institution can take account of its unique situation in considering its business activities, risk management sophistication, implementation requirements and the impact of any U.S. rule divergence from the Accord.

We note that the OCC, in its Regulatory Impact Analysis, provided a summary of the costs and benefits of permitting all Basel II credit approaches (Alternative A) and all operational risk approaches (Alternative B). According to the OCC, *"The most significant drawback to Alternative A is the increased cost of applying a new set of capital rules to all U.S. banking organizations."*[20] The OCC reached an identical conclusion for all alternative operational risk approaches. We disagree with this assessment. In particular, permitting non-core banks a choice among existing capital rules and the Basel II approaches will result in appropriate decisions incorporating cost/benefit trade-offs.

We recommend that all U.S. banks, including large internationally active banks, be given the option to adopt any of the Accord approaches, including the Standardized approach, consistent with the Accord and without provisions that such approaches be transitional. This option, in our view, is an effective means to improve the risk sensitivity of capital requirements for all banks regardless of their size.

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[19] "Results of the Fifth Quantitative Impact Study (QIS5)." *Basel Committee*, June 16, 2006.

[20] *Federal Register*, Vol. 71, No. 185, September 25, 2006: p. 55909. See also "Regulatory Impact Analysis for Risk-Based Capital Standards: Revised Capital Adequacy Guidelines." *OCC International and Economic Affairs*, 2006.

IV. Capital Requirements for Credit Risk

We now turn to specific requirements for calculating capital for credit risk that depart from the Accord and can potentially distort relative risk based capital requirements, as opposed to issues related to the overall approach and constraints on total capital addressed in the previous section.

As the agencies state in the NPR, *"In combination with other supervisory assumptions and parameters underlying this proposal, the IRB framework's 99.9 percent nominal confidence level reflects a judgmental pooling of available information, including supervisory experience. The framework underlying this proposal reflects a desire on the part of the agencies to achieve* ***relative*** *risk based capital requirements across different assets that are broadly consistent with maintaining at least an investment grade rating (for example, at least BBB) on the liabilities funding those assets, even in periods of economic adversity."*[21]

We agree with this statement and believe that the Accord, as well as many aspects of the NPR, represents an important step toward achieving relative capital consistency based on risk. However, we note several key differences in credit risk parameters, definitions and formulas between the NPR and the Accord that conflict, in our view, with this goal. These include:

A. Definition of Default
B. Downturn LGD
C. Wholesale Securitization Issues
D. Limited Recognition of Credit Hedges
E. Hedge Fund and Equity Exposure Treatment
F. Other Capital Formula Changes

These changes typically do not result in proportional change in capital across all exposures and thus distort the relative consistency of risk based capital requirements. Furthermore, due to these departures, NPR-based capital requirements for the same exposure will differ from those in other jurisdictions, creating unnecessary requirements for multiple systems.

A. Definition of Default

As stated in the NPR, *"Under the proposed rule's definition of default, a bank's wholesale obligor would be in default if, for any credit exposure of the bank to the obligor, the bank has*

> *(i) placed the exposure on nonaccrual status consistent with the Call Report Instructions or the Thrift Financial Report and the Thrift Financial Report Instruction Manual;*

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[21] *Federal Register*, Vol. 71, No. 185, September 25, 2006: p. 55834.

(ii) taken a full or partial charge-off or write-down on the exposure due to the distressed financial condition of the obligor; or

(iii) incurred a credit-related loss of 5 percent or more of the exposure's initial carrying value in connection with the sale of the exposure or the transfer of the exposure to the held-for-sale, available-for-sale, trading account, or other reporting category."[22]

In contrast, the Accord defines an obligor in default *"when either or both of the two following events have taken place.*

- *The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as realising security (if held).*
- *The obligor is past due more than 90 days on any material credit obligation to the banking group. Overdrafts will be considered as being past due once the customer has breached an advised limit or been advised of a limit smaller than current outstandings."*[23]

Under the Accord, indications of "unlikely to pay" include the criteria listed in the NPR definition: nonaccrual, charge-off or provision and sale at a material credit-related economic loss. The Accord, unlike the NPR, does not specify a numeric threshold for material credit loss. The NPR definition, however, requires that upon recognition of a 5% or more loss on sale or transfer of any one exposure to an obligor, all of that obligor's exposures must be considered in default. The Accord reads that the bank makes the determination whether the obligor is unlikely to pay, whereas the NPR is prescriptive in mandating such a determination based on the 5% threshold.

The 5% credit loss threshold is not appropriate in our view for the following reasons:

- We do not consider a 5% reduction in value to be a default. There are a number of possible reasons why a bank may wish to sell at a 5% credit-related loss without necessarily concluding that the obligor is unlikely to pay.

- Adherence to a numeric threshold will lead to the creation of multiple data sets. Two data sets would be required for international banks in certain home-host situations calculating one PD for U.S. regulatory purposes and a second PD for another jurisdiction, with corresponding differences in resulting capital calculations. Even firms without such home-host considerations may find calculating PD and capital using the 5% threshold to be unrealistic for internal risk management purposes, again leading to multiple data sets.

- The rule may result in an additional number of deemed defaults with only a minor impact on current regulatory capital. If more exposures are placed in default due

[22] *Federal Register*, Vol. 71, No. 185, September 25, 2006: p. 55846.
[23] "International Convergence of Capital Measurement and Capital Standards" *Basel Committee*, June 2006: Par. 452.

to this threshold and subsequently do not result in charge-offs, then historical PDs will be higher and longer term historical LGD will be lower. As data is accumulated or revised using this definition, the result may overall actually reduce computed capital with a significantly increased implementation and ongoing process burden and little benefit.

- The 5% threshold is prescriptive whereas the Accord is principles-based and provides flexibility in determining when a loss on sale or transfer is material.

- The 5% threshold creates an unnecessary and undesirable disincentive to sell or transfer such assets.

For these reasons, we oppose specification of 5% or any other fixed number defining a material credit-related loss and triggering default and request that the agencies instead adopt the definition in the Accord. Specifically, a material credit-related loss on sale or transfer should be considered an indication the obligor is unlikely to pay, providing needed flexibility on this matter, consistent with existing regulation and supervisory requirements.

B. Downturn LGD

Below, we discuss some key concerns related to:
1. Supervisory Mapping Formula for LGD
2. Downturn LGD
3. Multiple LGDs in Capital Formulas

1. Supervisory Mapping Formula for LGD

The agencies propose use of a supervisory mapping formula as an alternative to internal estimates for downturn LGD. As stated in the NPR, *"Under the proposed rule, a bank that does not qualify for use of its own estimates of LGD for a subcategory[24] of exposures must instead compute LGD by applying a supervisory mapping function to its internal estimates of ELGD for such exposures. The bank would adjust its ELGDs upward to LGDs using the linear supervisory mapping function: LGD = 0.08 + 0.92 x ELGD."*[25]

The choice between the supervisory mapping LGD and the bank's internal estimate of LGD is severely limited by the requirement that either all exposures within the very broadly defined subcategories qualify for use of internal LGD or none qualify. The use of the proposed supervisory mapping in conjunction with this "all-or-none" standard creates two difficulties. First, if just a few exposures in a broad subcategory do not meet the requirements for use of internal LGD estimates then the entire category must use the

[24] The five subcategories defined in the NPR consist of two broad wholesale categories (high volatility real estate and all other wholesale) and three broad retail categories (residential real estate, qualifying revolving credit, and all other retail).
[25] *Federal Register*, Vol. 71, No. 185, September 25, 2006: p. 55848.

supervisory mapping LGD. Second, for low to mid-range LGD values, the supervisory mapping LGD results in an arbitrarily large percent increase in capital.

For wholesale exposures with default-weighted average LGD (ELGD) of 40%, for example, assuming that the vast majority of exposures met the requirements to use internal estimates, this "all-or-none" rule would require LGD (and capital) to be set 12% higher than default-weighted average LGD (and capital) as a result of supervisory mapping, even if sound internal estimates for the majority of exposures do not justify this increase.

The supervisory mapping function also produces progressively larger percentage increases in LGD as ELGD decreases, which translates directly into larger percentage increases in capital as ELGD declines. For an ELGD of 25%, supervisory LGD would be 31%, or 24% higher than ELGD. For an exposure with a 2% ELGD, supervisory LGD would be 500% higher. The formula also imposes an effective floor of 8% on LGD, which would not be appropriate for certain types of exposures with negligible losses even in downturn environments. We are unaware of any empirical analysis that supports the proposed supervisory mapping formula. We oppose the use of a supervisory mapping function that arbitrarily imposes higher percentage increases in required LGD and capital as default-weighted average LGD values decline.

We are also concerned that the supervisory mapping formula would create a "de facto" standard that supervisors might incorporate as a leading consideration in the approval process for use of "own estimate" LGD. We recognize that the proposal for a supervisory mapping formula in combination with an "all-or nothing" approach to approval of internal estimates for broad subcategories of exposures is consistent with the guidance of the Basel Committee as a fallback solution.[26] We request that this fallback solution not be triggered automatically, without first attempting to take into account conservatism imbedded in a bank's internal estimates.

The implications for the internal estimation of downturn LGD is discussed in the next section.

2. Downturn LGD[27]

In situations where LGD cannot produce credible and reliable internal estimates for any exposure in conformance with the supervisory standards for use of internal estimates of LGD, the agencies are proposing either to apply the supervisory formula to all exposures in the same category or, alternatively, disqualifying the bank entirely from adopting the advanced approach.

With respect to standards for internal estimates of downturn LGD: *"the Committee has determined that a principles-based approach to elaborating on the requirements of paragraph 468 is most appropriate at this time. This approach is intended to ensure that*

[26] "Guidance on Paragraph 468 of the Framework Document", *Basel Committee*, July 2005.
[27] Downturn LGD is discussed in detail in Appendix A of this letter.

banks have systems in place for identifying downturn conditions and for incorporating these conditions into LGD estimates where appropriate. The principles articulated in this document are designed to be flexible enough to allow for a range of sound practices and to encourage continued work in this area, while also clarifying the Committee's expectations. These principles are not intended to amend the Revised Framework or to introduce any new rules".[28] We agree with this principles-based approach outlined by the Basel Committee.

In evaluating the strength of internal estimates of LGD, we request that the agencies first consider the extent to which internal conservatism has already incorporated and perhaps even overstated downturn LGD. These considerations include choice of discount rates, analysis of collateral present at the time of default versus at origination and analysis of exposure reduction prior to default. The latter considerations tend to overstate the LGD percentages when applied to the non-defaulted segments of the portfolio. We oppose mandatory use of a supervisory formula, which should not substitute for the use of conservative internal estimates of downturn LGDs. We also request that the agencies consider the materiality of relatively small subsets of exposures where reliable estimation is not feasible.

3. Multiple LGDs in Capital Formulas

The NPR capital formulas differ from the Accord formulas due to the introduction of multiple LGD parameters. The Accord capital formulas use only one LGD parameter that reflects economic downturn conditions and is not less than the long run default-weighted average loss rate.[29] The NPR capital formulas, however, employ both a downturn LGD and an additional parameter ELGD, defined as the bank's empirically-based estimate of the default-weighted average economic loss per dollar of EAD in the event of default within a one-year horizon. ELGD replaces LGD in the PD times LGD portion of the formulas.

As a result of this change, U.S. capital calculations will differ from those in other jurisdictions for the same exposure. The NPR capital requirement for unexpected loss will be higher and expected credit loss (ECL) will be lower than corresponding amounts computed using the Accord formula. These effects are partially offsetting, although the NPR requirements may be higher when the impact of maturity adjustment is taken into account. In combination with use of a different definition of default and possible mandatory supervisory mapping formula for LGD, the resulting capital is no longer comparable to the international calculation. Regardless of the magnitude of the combined net impact, which we believe will result in higher capital under the NPR rules, there is little justification for the introduction of ELGD in the formula without prior consultation with the Basel Committee given this lack of international comparability.

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[28] "Guidance on Paragraph 468 of the Framework Document", *Basel Committee*, July 2005.

[29] "International Convergence of Capital Measurement and Capital Standards" *Basel Committee*. June 2006: Par. 468.

We recommend that the ELGD parameter be dropped from the capital formulas so they conform to the Accord. Any future need for change should be addressed by the Basel Committee to avoid the use of different formulas in different jurisdictions.

C. Wholesale Securitization Treatment

We have two major concerns about the proposed rules for securitization exposures: the scope of application of securitization treatment and the application of the hierarchy of securitization approaches for several specific classes of exposures.

1. Scope of Application

We remain concerned that the scope of the securitization treatment may be overly broad and may encompass exposure categories that were never contemplated to be incorporated as securitizations, such as hedge funds. While we appreciate the intent to define securitization transactions based on economic substance rather than legal form, we believe that this treatment category has been broadened to include transactions that are more appropriately treated under rules for other exposure categories.

2. Application of the Hierarchy to Certain Classes of Exposures

Treatment of SIVs under the IAA

Structured Investment Vehicle (SIV) transactions tranche a pool of highly rated underlying assets into two pari-passu tranches (i) A-1/P-1 commercial paper (CP) and (ii) AAA/Aaa rated medium term notes (MTN). Protection is provided to the CP and MTNs by the first loss tranche or capital notes. We provide liquidity facilities that support the issuance of the A-1/P-1 rated CP. Basing the RWA for the liquidity facility on the risk of the capital notes is not a true measure of the risk of that facility.

The best measure of risk of the liquidity facilities in SIV transactions is the internal risk rating that is applied to these facilities. This rating is developed using many of the same criteria that are employed for ratings of liquidity facilities that support asset backed commercial paper (ABCP) Conduits. The structure of an SIV is similar in many aspects to an ABCP Conduit and generally these transactions meet the NPR qualification criteria that an ABCP Conduit must meet to qualify for the IAA. Therefore, we suggest that SIVs and other transactions which meet the qualification criteria similar to ABCP Conduits be permitted to use the IAA.

Risk Weight of Senior Securitization Exposures

We believe that a senior securitization exposure (super senior) which is senior to the AAA tranche in a transaction is less risky than the AAA tranche and therefore should require a lower risk weight. Many securitization transactions include a swap, liquidity facility, or other transaction that is in a super senior position and has a first priority claim on the underlying assets. These transactions are clearly senior in the waterfall to the AAA tranche. In the event of a default, the AAA tranche provides credit protection to the super senior tranche. Therefore, we believe that the risk weight of the super senior

tranche could be improved. For example, as described in the European Union CRD: *"A risk weight of 6% may be applied to a position in the most senior tranche of a securitization where that tranche is senior in all respects to another tranche of the securitization positions which would received a risk weight of 7%."*[30]

Alternate Approach to K_{IRB} where Underlying Assets are not Internally Rated
The market standard for securitization transactions such as CDOs requires that the underlying assets are rated by a nationally recognized statistical rating organization (NRSRO). Securitization transactions may have hundreds of underlying assets. It would be inefficient to also assign internal ratings to each of the underlying assets. Therefore, we propose as an alternative to the NPR that if a bank can demonstrate a close concordance between NRSRO ratings and internal ratings, then it should be able to assign the internal PD to the asset based on the mapped internal rating.

Treatment of Freddie Mac and Fannie Mae Securities
We seek clarification of the treatment of mortgage-backed pass-through securities which do not have external ratings but are guaranteed by Fannie Mae or Freddie Mac. We propose that we apply their corporate ratings to the securities.

Treatment of Securitization Exposures in the form of Non-Credit OTC Derivatives
We request changes to the treatment of securitization exposures in the form of non-credit OTC derivatives.

We have generally understood that the securitization framework in the Basel II NPR would not apply to trading book exposures, such as non-credit OTC derivatives. However, section 42(e) appears to indicate that non-credit OTC derivative exposures to securitization SPEs will be considered securitizations.

We believe the securitization framework will not provide an appropriate risk weight for many of these exposures. For example, where a non-credit OTC derivative exposure is pari passu with a rated tranche, its risk weight will be inferred from a junior tranche. This will result in a significantly higher risk weight. This treatment does not reflect the economic risk of the exposure.

A dialogue related to this issue is underway between the FSA and various UK banks. We request that the agencies review this issue in consultation with the Basel Committee.

D. Limited Recognition of Credit Hedges

Although we support the introduction of the Double Default framework as a more advanced approach, we believe that the overall treatment of credit risk mitigants still contains significant shortcomings and would encourage the agencies to reconsider the proposed treatment in concert with the Basel Committee.

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[30] European Union Capital Requirements Directive 2006/48/EC, June 14, 2006

In general, the proposed treatment fails to provide appropriate regulatory capital relief to incent the use of credit hedges as risk mitigants. For example, with the restrictiveness of the Double Default framework banks will still receive no capital benefit for a loan to a AA rated financial entity that is hedged by another AA rated financial entity, even though both highly-rated parties would have to default at the same time in order for the bank to experience an economic loss. In fact, banks will have to add a counterparty credit capital charge for the hedge in addition to the banking book charge for the exposure to the AA financial entity. As a result in these scenarios, the rules still require that banks hold more capital than if they had not hedged at all.

Our primary concerns around the treatment of credit risk mitigants relate to the following areas:

1. Restrictions on Double Default Eligibility
2. Calibration of the Double Default Formula
3. Maturity Mismatch Haircut
4. Restructuring Haircut

1. Restrictions on Double Default Eligibility

Only in very limited situations does the proposed approach recognize the lower risk of joint default when credit hedging. Specifically, Double Default treatment can be applied only if the requirements below for both the protection provider as well as the underlying exposure are satisfied:

- Protection provider must be a financial institution or insurance company in the business of providing credit protection with an internal rating of at least A- at the time the protection was bought and a current rating of at least investment grade.
- Underlying exposure must not be a sovereign exposure, an exposure to an eligible double default protection provider or an exposure to an affiliate of the protection provider.

Regarding the criterion that the underlying exposure cannot be to a financial institution, we do not share the agencies' view that there exists excessive correlation between financial institutions that is not already accounted for in the highly conservative correlation factors used to derive the K_{DD} formula. We support the joint Associations' response to the 2005 Trading Book Review on this particular issue.[31] In addition, there is an inconsistency in that a financial hedging a corporate exposure can be recognized as Double Default-eligible but a corporate hedging a financial exposure is ineligible.

Furthermore, we oppose the A- rating requirement for the protection provider as it creates a deterrent for banks to buy protection from financial institutions which were previously rated below A-. In addition, we do not understand the relevance of using the protection provider's historical rating when the protection was obtained as long as the current rating

[31] "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects: a response to the Basel/ IOSCO Consultation", joint Associations (ISDA, IIF, LIBA, TBMA, IBFed, BBA, FOA), May 2005.

of the protection provider is available. We would also like to highlight this operationally burdensome requirement as another NPR inconsistency with the Accord, which states that the protection provider should have an internal rating of at least A- at the time the protection was first provided or for any period of time thereafter.[32]

2. Calibration of the Double Default Formula

We support the joint Associations' conclusion that the calibration of the Double Default (K_{DD}) formula is excessively conservative for the following reasons:

- Considering the stringent requirements to ensure unrelatedness between the protection provider and the reference obligor, the correlation factors underpinning the K_{DD} formula are highly conservative.
- The PD substitution approach yields a lower capital requirement than double default for non-investment grade reference obligors. This is counter-intuitive to credit risk management principles as it creates disincentives for buying protection on non-investment grade reference names.

3. Maturity Mismatch Haircut

We do not support the proposed approach for maturity mismatch haircuts as it significantly diminishes the risk mitigation benefit of credit hedges. Under this approach, a three-year hedge of a five-year loan would receive only 60% of the benefit of a five-year hedge of the same loan. The maturity mismatch haircut is compounded even further for reference obligors where a firm has multiple exposures with different residual maturities. In such cases, the bank is required to use the longest residual maturity of all of those exposures to calculate the maturity mismatch haircut. Moreover, the maturity mismatch haircut for credit hedges is disproportionately high compared to the proposed maturity adjustment required for underlying exposures.

To better account for maturity mismatches, one suggested approach would be to recognize the difference between the A-IRB capital for an asset with the exposure tenor and the A-IRB capital for an asset with the hedge tenor.

4. Restructuring Haircut

We believe that the 40% haircut for credit derivative hedges which do not include distressed restructuring as a credit event is unjustifiably high, especially when compounded with the maturity mismatch and FX mismatch haircuts. Continuing the example above where a three-year hedge of $100 covering a five-year loan of $100 is effectively reduced to a $60 hedge with the maturity mismatch haircut, the hedge notional would be further decreased to $36 if the contact did not include distressed restructuring as a credit event. We encourage the agencies to consider the research done to date by industry associations to estimate an appropriate discount for the lack of restructuring.

[32] "International Convergence of Capital Measurement and Capital Standards", *Basel Committee*, June 2006, Par. 307.

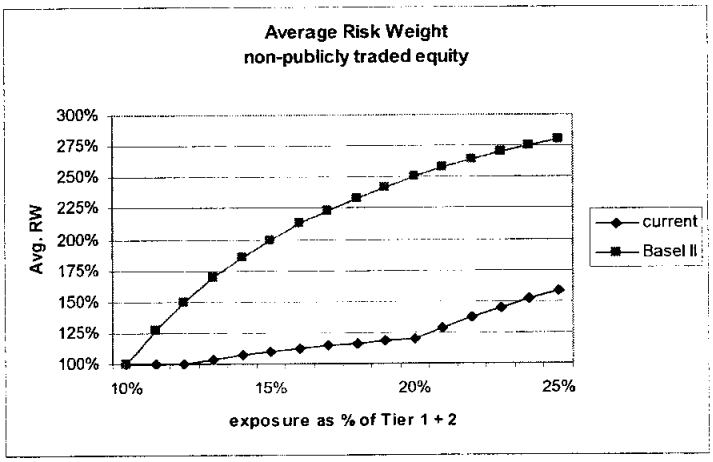
We recognize and support the need for the agencies to reopen the dialogue with the Basel Committee on these points and consider these issues to be a high priority for Basel Committee consideration.

E. Hedge Fund and Equity Exposure Treatment

Consistent with our support for greater risk sensitivity, we recognize and support the concept that higher risk assets should attract higher capital. As a case in point, the proposed approaches for equity exposures will result in higher capital relative to current U.S. rules due to a broader definition of equity and increased capital requirements for those institutions with significant equity portfolios. We agree with the broader definition of equity based on the economic substance of the instrument, in place of the current rule based more narrowly on specific banking powers.[33]

Under the proposed simple risk weight approach (SRWA), incremental equity exposure above the 10% Tier 1 plus Tier 2 threshold would be risk weighted at 300% and 400% for publicly and non-publicly traded equity, respectively. Under current U.S. rules, capital requirements increase at two different threshold levels: 15% and 25% of Tier 1 capital. Based on the mix of regulatory capital elements at large banks, the NPR threshold of 10% of total risk-based capital will be more restrictive than the current 15% of Tier 1 threshold.[34]

For firms with equity exposure in excess of 10% of regulatory capital, RWA under the SWRA will be substantially higher than RWA under current rules. The graph below illustrates the estimated impact of the SRWA approach to significant portfolios consisting entirely of non-publicly traded equity.



As an alternative to this approach, firms can elect an internal model approach (IMA) subject to separate supervisory approval and with substantial floors. The floors of 200%

[33] "Nonfinancial Equity Investments." *Federal Register*, Vol. 67, No. 17, January 25, 2002: p. 3784-3807.
[34] Based on recent Y-9C data for large bank holding companies, we estimate the current 15% Tier 1 threshold is roughly equivalent to a 12% Tier 1 plus Tier 2 capital threshold under Basel II.

and 300% (for publicly traded and non-publicly traded equity, respectively) would apply to all equity exposures whereas a 100% risk weight would apply to exposures less than 10% of regulatory capital under the SRWA (so-called "non-significant exposures). This would discourage firms from adopting the IMA approach. As an incentive, we support 100% risk weight for non-significant exposures under the IMA approach as well.

While the NPR market-based approaches appear to be directionally more risk sensitive, we have the following concerns:

1. Treatment of Investment Funds with Material Liabilities
2. Treatment of Hedge Funds
3. Look-Through Approach Risk Weights
4. Hedge Pair Risk Weights

1. Treatment of Investment Funds with Material Liabilities

Under the definition of investment fund in the NPR, investment funds "with material liabilities" are excluded from investment fund treatment. The NPR is unclear on the proposed treatment. We support a change to the NPR that would explicitly include investment funds with material liabilities in the definition of equity but not as investment funds.[35] We recommend such a fund, if in the banking book, be explicitly risk weighted in a manner similar to a non-publicly traded equity.

In industry discussions, regulatory staff have suggested that investment funds with material liabilities might be treated as the equivalent of the bottom tranche in a two tranche securitization structure, junior to the fund's liabilities. This securitization treatment would result in a regulatory capital deduction for the full amount of a bank's holding in the fund.

We strongly oppose this securitization approach. We recognize the agencies' concern over leverage, but suggest that while appropriate risk weights might be somewhat higher than proposed risk weights for other equity positions, they should not be as extreme as the equivalent of a full capital deduction. In addition, this securitization logic could also be applied to a firm's common stock where the firm's debt represents materially leverage. This securitization approach creates inconsistent risk weightings by requiring a capital deduction for investment funds with liabilities while at the same time equity positions in leveraged public and non-public companies are subject to risk weights of 300% and 400%. We do not see sufficient evidence to make this large a distinction in terms of degree of risk.

There is no explicit mention or rationale provided for what is, in effect, an implied automatic default to securitization treatment in the NPR text. We are concerned that such

[35] Our view is based on Part VI, Section 51of the NPR: p.55943. "To calculate its risk weighted asset amounts for equity exposures *that are not equity exposures to investment funds*, a [bank] may apply either the Simple Risk Weight Approach (SRWA) in section 52 or, if it qualifies to do so, the Internal Models Approach (IMA) in section 53."

securitization treatment could apply to other exposures since, in every definition of an exposure category, the phrase "unless it is a securitization exposure" appears. We strongly oppose securitization treatment for exposures that are not synthetic securitizations.

2. Treatment of Hedge Funds

The NPR is silent on the treatment of hedge funds in the banking book. For the same reasons given in the prior section, hedge funds should explicitly be treated under the rules for equity exposures, with an explicit risk weight, similar to non-publicly traded equity. We believe this is the most consistent treatment for such exposures, rather than investment fund treatment. We likewise oppose securitization treatment for hedge funds in either the trading or banking book, for the same reasons stated above. Also, consistent with the proposed rule excluding trading book positions from equity rules, hedge funds in the trading book should remain in the trading book, as covered positions subject to market risk rules.

3. Look-Through Approach Risk Weights

Under the modified look-through approaches for investment funds, any holding of an investment fund that would require a risk weight in excess of 400% if it were instead a direct exposure of the bank (under AIRB rules), would be assigned a risk weight of 1250%. We believe there is a need for more granular risk weights between 400% and 1250% under the modified look-through approaches for investment funds. We also seek clarification of the types of holdings that would be included in this exposure class. We believe that the gap between 400% and 1250% for investment funds is too large and that 1250% is an excessively punitive risk weight for firms meeting the 10% total risk-based capital requirement to be well-capitalized.[36]

4. Hedge Pair Risk Weights

Since the effectively hedged portion of a hedge pair entails negligible risk, we propose that this risk weight should be either zero or at most no more than the 7% floor for investment funds, not 100% as proposed. We also support extension of this treatment to individual non-publicly traded equities.

[36] For banks exceeding the well-capitalized risk-based capital standards, risk weights above 1000% represent a higher capital requirement than a full deduction from regulatory capital. For exposures where the maximum loss cannot exceed the amount of exposure, risk weights above 1000% equate to additional required capital where there is no possibility of loss.

F. Other Capital Formula Changes

In a number of instances the NPR differs significantly from the Accord by requiring different inputs to the capital formulas. In some cases the differences are not material in terms of the resulting capital requirement. In these cases our view is that they add to cost and complexity but produce no benefits and should instead conform to the Accord. In other cases differences are material and distort capital consistency contrary to Basel II objectives. In addition, for some banking organizations under certain home/host situations these differences create the need to compute, validate and archive multiple sets of capital calculations for the same exposures.

Below, we discuss concerns related to:

1. Capital for Small and Medium Sized Enterprises
2. Credit Conversion Factors
3. Capital for Defaulted Exposures
4. Retail Seasoning

1. Capital for Small and Medium Sized Enterprises

For small and medium sized enterprises (SME), the NPR capital formula eliminates the sales size adjustment factor contained in the Accord formula which was intended to recognize the more idiosyncratic nature of defaults for this exposure class. The change in the NPR formula results in an increase in the correlation factor and the capital requirement. For example, for an obligor with sales size of $20 MM the NPR capital would produce 19% higher capital. While we acknowledge that the NPR may be departing from the Accord out of concern that the treatment of SME capital may have been overly aggressive, nevertheless the result is still a difference between the NPR and the Accord. We suggest that either the NPR conform to the Accord or, if there is a valid concern, revisit this issue with the Basel Committee.

2. Credit Conversion Factors

Under the definition of exposure at default (EAD), the NPR states that for off-balance sheet contingent exposures such as letters of credit, guarantees and risk participations, the EAD should equal the notional amount of the exposure. This implies that a 100% credit conversion factor (CCF) must be used for these types of exposures. However, the Accord allows banks under the advanced approach to use their own internal estimates of CCFs across different product types provided the exposure is not subject to a CCF of 100% in the Foundation approach. To maintain consistency with the international banks, we recommend that U.S. banks with well-established internal CCFs for contingent exposures be permitted to apply these CCFs in the estimation of EAD.

3. Capital for Defaulted Exposures

Under the NPR rules, the capital requirement for a wholesale defaulted exposure is determined by comparing:

- 8% multiplied by the EAD of the wholesale exposure, plus the amount of any charge-offs or write-downs on the exposure; or
- K for the wholesale exposure (immediately before the obligor defaulted), multiplied by the EAD of the wholesale exposure immediately before the obligor defaulted.

The above requirement to use historical PD, LGD and EAD estimates at an exposure level for quarterly RWA reporting is unduly burdensome. Operationally, it would necessitate extracting exposure-specific data at different points in time and result in significantly more processing time and data storage requirements. In addition, the relevance of the risk parameters (e.g. PD, LGD, EAD) associated with the exposure before default is unclear.

We recommend applying a treatment for defaulted exposures that is consistent with the Accord, which relies on the current risk parameters associated with the exposure.

4. Retail Seasoning

In the 2004 retail guidance the agencies identified seasoning as an issue, particularly for longer-maturity consumer products such as residential mortgages.[37] Both the NPR and the retail guidance proposed to address seasoning by requiring the calculation of the annualized cumulative default rate (ACDR) over the expected remaining life of unseasoned segments. Reasonable exceptions are created for seasoned segments (per the retail guidance) and retail exposure subcategories or segments for which seasoning is immaterial. However, in our view, this calculation method:

- Does not fully and directly address portfolio age and performance concerns, instead relying solely on PD adjustments that may not properly capture increased risk.
- Does not properly account for portfolio attrition, since prepayment is only factored into the estimation of expected remaining life for each exposure but is not integral to the subsequent ACDR calculation. The prescribed method of calculation is both inadequate and unduly burdensome by requiring separate PD calculations.
- Increases the applicable time period for covered exposures from one year to an overly-conservative time frame, varying by product based on expected life estimates.

The industry recognizes that there is often a time pattern to default rates as accounts season, but age does not tend to be a key risk driver after other risk factors are taken into account. We therefore do not see seasoning per se as a primary risk concern. The issue is rather a potential capital shortfall based on migration patterns as the portfolio ages. The

[37] *Federal Register*, Vol. 69, No. 207, October 27, 2004: p. 62760 (Paragraphs 109-112).

Accord, which also identifies seasoning as an issue, addresses this without prescribing an ACDR calculation, as follows:

Banks should anticipate the implications of rapid exposure growth and take steps to ensure that their estimation techniques are accurate, and that their current capital level and earnings and funding prospects are adequate to cover their future capital needs. In order to avoid gyrations in their required capital positions arising from short-term PD horizons, banks are also encouraged to adjust PD estimates upward for anticipated seasoning effects, provided such adjustments are applied in a consistent fashion over time.[38]

The revised Supervisory Guidance (Guidance) recognizes that there may be alternative means of addressing similar concerns such as downturn LGD, for example. In that spirit, we request that the agencies consider the following more comprehensive approach to adjust capital requirements for seasoning effects.

Include Age in Segmentation Analysis. If unseasoned accounts were over-represented in the development portfolio (relative to the actual portfolio mix in a subsequent period) and the risk segmentation process did not include an age variable, PDs might be underestimated. To address this concern, preliminary segmentation analysis should initially include at least one age variable. If age or another time-based variable is determined to be a significant risk driver, then seasoning is material and directly addressed in PD estimation. If age is not significant, any capital impact is either immaterial or is already captured by other variables. This approach is consistent with the Guidance's requirement to determine whether seasoning is a material risk factor or not (S4-18, para. 76).

Perform Migration Analysis. If unseasoned accounts were under-represented in the development portfolio (relative to the actual portfolio mix in a subsequent period), computed capital could be low relative to subsequent capital required as the portfolio seasons. To correct for this potential shortfall, a separate migration analysis would be performed to assess additional capital for unseasoned segments as follows: project account migration across segments for the succeeding year or years; calculate expected future RWA based on migration; in the event of projected materially higher capital, adjust RWA upward by the estimated amount.

This two part approach has the following advantages:

- Adjustments are made directly to capital, not indirectly via PD;
- This approach simultaneously captures PD, LGD and attrition factors, e.g. aging portfolios may exhibit higher PDs but associated with significantly fewer accounts;
- The segmentation test separates seasoned from unseasoned exposures;

[38] Paragraph 467 of the Accord.

- The approach measures both materiality of aging and the magnitude of the actual RWA adjustment;
- This approach is conservative in that it covers capital required for the succeeding year plus future marginal capital needs due to seasoning.

We believe this combined approach more directly addresses seasoning concerns, as well as being more practical and less burdensome. We request that the agencies permit this and similar alternatives in lieu of the ACDR requirement. The ACDR method is not contained in the Accord and is neither the best nor the only approach to addressing seasoning concerns. More broadly, we encourage the agencies to permit banks the necessary flexibility to develop their own internal approaches to address retail seasoning.

V. Capital Calculations for Operational Risk

In general, the portion of the NPR governing operational risk remains basically unchanged from the ANPR issued two years ago. We remain highly supportive of the principles which have carried through to the NPR of a risk-based, flexible approach to operational risk measurement and management.

A. General Comments

Specific items in the original ANPR that have been noted and the subject of ongoing discussions remain largely unaddressed and open in the NPR. The keys areas of note here are: Home / Host issues, capital requirements (exclusions) for Expected Losses versus Unexpected Losses, requirements and computation of diversification benefits, computing capital for "significant" legal entities. Insofar as the NPR is drafted at such a high level for operational risk, it is difficult to determine whether these open items are critical issues for comment and debate or whether workable resolutions are at hand.

Notwithstanding these comments, below are some specific Operational Risk issues either proposed or discussed in the NPR that are worthy of note at this time.

B. Specific Operational Risk Issues

In addition to the general comments offered above there are two potential areas of concern that are proposed / discussed in the NPR: (1) capital requirements for fixed assets and (2) regulatory mandated parameters for the calculation of operational risk capital.

1. *Capital requirements for fixed assets.* The regulatory proposal to compute capital for fixed assets is flawed in two dimensions. First, the proposal creates a capital charge for "risk-weighted asset amounts for assets that are not included in an exposure category". Secondly, the proposal suggests that additional capital may be required as the carrying value of such assets on the balance sheet can be substantially less than market or replacement value. We strongly believe that such a capital charge is

unnecessary and inappropriate as:

a. The potential loss associated with such assets and the requisite level of capital for such risk is indeed already captured along with other operational risks within the LDA approach under the risk category of "Damage to Physical Assets". Historic losses, both internal and external, are tracked and monitored similar to all other operational risk categories. The risk associated with Fixed Assets is analyzed within our Scenario Analysis exercise and all capital requirements for these risks are included in any computation of overall operational risk capital.

b. The existing Basel I approach to capital for Fixed Assets is not risk-based, it grossly overstates the level of capital required and is not supported whatsoever by the historic losses associated with such assets.

c. In addition, the concept of holding incremental capital for the difference between market or replacement value and the book or carrying value of Fixed Assets is asymmetrical and also flawed. First, no capital credit is given for the under-valued nature of these assets. Secondly, the logic that holding under-valued assets on the balance sheet implies the need for additional regulatory capital would infer that holding 'over-valued' assets would indeed free up capital.

2. *Regulatory mandated parameters for the calculation of capital.* The NPR proposes that regulatory agencies should reserve the authority to prescribe specific parameters and other input variables and techniques for the calculation of operational risk capital. We are strongly opposed to this approach on the belief that:

    a. It is inappropriate as it is directly contrary to the spirit and principles of the AMA. Removing such authority and discretion from the AMA banks will substantially reduce the level of analytics and innovation currently devoted to the measurement of operational risk. Further and beneficial development in this emerging discipline will likely stagnate;

    b. It is unnecessary as remedies already exist under Pillar 2 to address situations where capital requirements are believed to be understated. These remedies do not require regulatory authorities to micro manage capital computation;

    c. It is impractical insofar as under such an approach parameters and input variables governing operational risk capital calibration would need to be monitored, tested and possibly adjusted on a regular, even quarterly, basis for all AMA institutions. We do not believe this is a workable or desirable scenario for the regulatory authorities.

VI. Responses to Specific Questions in the NPR

A. Basel II conceptual overview, scope and transition rules (Q. 1-12)

Question 1: *The IRB risk-based capital formulas contain supervisory asset value correlation (AVC) factors, which have a significant impact on the capital requirements generated by the formulas. The AVC assigned to a given portfolio of exposures is an estimate of the degree to which any unanticipated changes in the financial conditions of the underlying obligors of the exposures are correlated.*
High correlation of exposures in a period of economic downturn conditions is an area of supervisory concern. For a portfolio of exposures having the same risk parameters, a larger AVC implies less diversification within the portfolio, greater overall systematic risk, and, hence, a higher risk-based capital requirement.

The AVCs that appear in the IRB risk-based capital formulas for wholesale exposures decline with increasing PD; that is, the IRB risk-based capital formulas generally imply that a group of low-PD wholesale exposures are more correlated than a group of high-PD wholesale exposures. Thus, under the proposed rule, a low-PD wholesale exposure would have a higher relative risk-based capital requirement than that implied by its PD were the AVC in the IRB risk-based capital formulas for wholesale exposures fixed rather than a function of PD. This inverse relationship between PD and AVC for wholesale exposures is broadly consistent with empirical research undertaken by G10 supervisors and moderates the sensitivity of IRB risk-based capital requirements for wholesale exposures to the economic cycle.

The agencies seek comment on and empirical analysis of the appropriateness of the proposed rule's AVCs for wholesale exposures in general and for various types of wholesale exposures (for example, commercial real estate exposures).

Response 1: The specific AVC selected by the Basel Committee cannot be easily validated nor deemed appropriate based purely on empirical grounds, though there are theoretical approaches to estimating AVCs for wholesale exposures based on empirical data. While it is understood that the non-conservative assumption of an infinitely granular portfolio subject to a single systematic risk factor may need to be offset by a suitably conservative AVC assumption, the choice of that compensating AVC appears designed to meet the Basel's Committee's objective of little regulatory capital change from Basel I levels. The fact that RWA requirements are insensitive to portfolio composition, such as industry and region, has been clearly established and to make up for this deficiency Pillar 2 reviews are thus required.[39]

It appears to be directionally correct that defaults associated with low PD obligors, often associated with larger obligors with more diversified operations, arise from greater susceptibility to macroeconomic factors. It is also reasonable that higher PD firms, often associated with smaller or more highly leveraged obligors, are more susceptible to idiosyncratic failures, such as those arising from management, strategy and competition,

[39] "Convergence of Credit Capital Models" *IACPM ISDA* February 2006, available at www.iacpm.org

in addition to systemic macro factors. As a result, it appears that defaults of high PD firms are more idiosyncratic than low PD firms.

However, the appropriate level of correlation for these two broad groups needs to be a function not only of their PD level but also their industry and regional characteristics as is demonstrated by Moody's KMV's R-square estimates. In the same manner, assuming a higher AVC for commercial real estate effectively presupposes a certain correlated portfolio composition that may not be as correlated as is inherently assumed. Commercial real estate portfolios, while arguably sensitive to interest rates, have different responses to macro factors depending on their two key dimensions--the type of property improvements and their localities. Some real estate portfolios that are concentrated along these two key dimensions may appear to be highly correlated in their response to these factors while other, more diverse portfolios may not. It follows then, that rather than adjusting AVCs, a Pillar 2 supervisory review of concentrations and stress conditions is the more appropriate place to evaluate capital adequacy for various types of wholesale exposures such as commercial real estate.

Question 2: *The agencies seek comment on and empirical analysis of the appropriateness and risk sensitivity of the proposed rule's AVC for residential mortgage exposures – not only for long-term, fixed-rate mortgages, but also for adjustable-rate mortgages, home equity lines of credit, and other mortgage products – and for other retail portfolios.*

Response 2: Determination of AVCs is more problematic for retail products, including residential mortgages, as compared to wholesale products. There are a number of theoretical approaches supported by empirical data that lend themselves to estimating AVCs for wholesale credit exposures. Retail products do not have the same empirical underpinnings. As a result, it is understandable why the Basel Committee selected relatively conservative AVCs for retail products.

However, there are indications that retail AVC values may be overly conservative. At the required 4% credit card AVC required capital levels are higher than those implied by market pricing and the 2003 RMA survey.[40]

Previous estimates for first mortgages (e.g. KMV estimates and the 2003 RMA industry survey) indicate appropriate AVC levels in the 8-11% range. For low PD segments, the loss distribution implied by the required 15% mortgage AVC is not realistic: for example, a 3 basis point PD segment would require a distribution with zero or near-zero losses in all periods except for one period of extreme losses in order to produce the distribution assumed by a 15% AVC.

Given the lack of robust data we suggest that the specified AVC levels be reviewed and potentially modified based on more reliable studies.

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[40] "Retail Credit Economic Capital Estimation – Best Practices", *the Risk Management Association*, February, 2003: p. 25 (credit card), pp. 24, 26-7 (mortgage).

Question 3: *The BCBS calibrated the proposed 0.6 percent limit on inclusion of excess reserves in Tier 2 capital to be approximately as restrictive as the existing cap on the inclusion of ALLL under the general risk-based capital rules, based on data obtained in the BCBS's Third Quantitative Impact Study (QIS-3). The agencies seek comment and supporting data on the appropriateness of this limit.*

Response 3: While this is consistent with the Accord, we believe there should be no limit on excess of ALLL over expected credit losses for inclusion in Tier 2 capital. We request the agencies to address this issue with the Basel Committee.

Question 4: *The agencies seek comment on the use of a segment-based approach rather than an exposure-by-exposure approach for retail exposures.*

Response 4: We agree with a segment-based approach for retail rather than an exposure-by-exposure approach. In our view, retail credit risk is best understood in terms of a set of key drivers with those dimensions then applied against mass consumer credit behavior. The segment-based approach is consistent with our internal capital discipline and analytic framework.

Question 5: *The agencies are, in short, identifying a numerical benchmark (10% or greater decline in aggregate minimum required risk-based capital) for evaluating and responding to capital outcomes during the parallel run and transitional floor periods that do not comport with the overall capital objectives outlined in the ANPR. At the end of the transitional floor periods, the agencies would re-evaluate the consistency of the framework, as (possibly) revised during the transitional floor periods, with the capital goals outlined in the ANPR and with the maintenance of broad competitive parity between banks adopting the framework and other banks, and would be prepared to make further changes to the framework if warranted. The agencies seek comment on this approach to ensuring that overall capital objectives are achieved.*

Response 5: Please refer to our previous comments in Section III. A.

Question 6: *The agencies seek comment on all potential competitive aspects of this proposal and on any specific aspects of the proposal that might raise competitive concerns for any bank or group of banks.*

Response 6: Please refer to our comments in Sections III – V. Our most significant concerns relate to departures from the Accord that create a non-level playing field for Basel II banks subject to NPR rules relative to all other competitors subject to the international text of the Accord.

Question 7: *The agencies request comment on whether U.S. banks subject to the advanced approaches in the proposed rule (that is, core banks and opt-in banks) should be permitted to use other credit and operational risk approaches similar to those provided under the Accord. With respect to the credit risk capital requirement, the agencies request comment on whether banks should be provided the option of using a*

U.S. version of the so-called "Standardized approach" of the Accord and on the appropriate length of time for such an option.

Response 7: We support the position that all U.S. banks should be permitted to adopt any of the alternative Basel II approaches, including the Standardized approaches for both credit and operational risk, as described in the Accord. Please refer to our comments in Section III. D.

Question 8A: *Under the proposed rule, a U.S-chartered bank holding company (BHC) is a core bank if the BHC has: (i) Consolidated total assets (excluding assets held by an insurance underwriting subsidiary) of $250 billion or more, as reported on the most recent year-end regulatory reports; (ii) consolidated total on-balance sheet foreign exposure of $10 billion or more at the most recent year-end; or (iii) a subsidiary depository institution (DI) that is a core bank or opt-in bank.*

The proposed BHC consolidated asset threshold is different from the threshold in the ANPR, which applied to the total consolidated DI assets of a BHC. The proposed shift to total consolidated assets (excluding assets held by an insurance underwriting subsidiary) recognizes that BHCs can hold similar assets within and outside of DIs and reduces potential incentives to structure BHC assets and activities to arbitrage capital regulations. The proposed rule excludes assets held in an insurance underwriting subsidiary of a BHC because the Accord was not designed to address insurance company exposures.

The Board seeks comment on the proposed BHC consolidated non-insurance assets threshold relative to the consolidated DI assets threshold in the ANPR.

Response 8A: No comment.

Question 8B: *A DI also is a core bank if it is a subsidiary of another DI or BHC that uses the advanced approaches. A bank that is subject to the proposed rule either as a core bank or as an opt-in bank would be required to apply the rule unless its primary Federal supervisor determines in writing that application of the rule is not appropriate in light of the bank's asset size, level of complexity, risk profile, or scope of operations.*

The agencies seek comment on the proposed scope of application. In particular, the agencies seek comment on the regulatory burden of a framework that requires the advanced approaches to be implemented by each subsidiary DI of a BHC or bank that uses the advanced approaches.

Response 8B: It would be a significant burden to large BHC's to monitor and file for each separate subsidiary of the BHC. The threshold defined in the NPR should exclude the following sentence: "*The agencies note that, using this approach to define whether a BHC is a core bank, it is possible that no single DI under a BHC would meet the threshold criteria, but that all of the BHC's subsidiaries would be core banks.*"[41]

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[41] *Federal Register*, Vol. 71, No. 185, September 25, 2006: p. 55841.

In the case of operational risk, not only would it be extremely burdensome, but calculation of capital in the absence of statistically sufficient loss data would require assumptions to be made in the model on the applicability of business scenarios to a given entity. We propose at most to calculate AMA for the BHC and potentially two other significant entities and use the Standardized or Basic Indicator approach for all other U.S. entities, consistent with the international approach.

***Question 9**: A U.S. BHC that meets the conditions in Federal Reserve SR letter 01–0122 and is a core bank would not be required to meet the minimum capital ratios in the Board's capital adequacy guidelines, although it would be required to adopt the advanced approaches, compute and report its capital ratios in accordance with the advanced approaches, and make the required public and regulatory disclosures. The agencies seek comment on the application of the proposed rule to DI subsidiaries of a U.S. BHC that meets the conditions in Federal Reserve SR letter 01-01 and on the principle of national treatment in this context.*

Response 9: No comment.

***Question 10:** To provide for a smooth transition to the advanced approaches, the proposed rule would impose temporary limits on the amount by which a bank's risk-based capital requirements could decline over a period of at least three years. Based on its assessment of the bank's ongoing compliance with the qualification requirements, a bank's primary Federal supervisor would determine when the bank is ready to move from one transitional floor period to the next period. In addition, the bank would calculate a Tier 1 leverage ratio using Tier 1 capital as defined in this proposed rule for the numerator of the ratio.*

The agencies seek comment on this approach, including the transitional floor thresholds and transition period, and on how and to what extent future modifications to the general risk-based capital rules should be incorporated into the transitional floor calculations for advanced approaches banks.

Response 10: See our comments in Section III. B, which recommend the transitional floor thresholds and periods rules conform to the Accord. Our interpretation of the proposed rule is that core banks adopting the advanced approaches at the earliest permissible date would have the option to apply current Basel I rules, not future modifications (i.e. Basel 1A rules) to transitional floor calculations. In our view, banks should have the option to use either Basel I or 1A rules in floor calculations in order to avoid the operational burden of building or retaining an additional set of capital calculations for a temporary period. Should a bank determine that any benefits of applying the Basel 1A floor outweigh cost considerations, it should be permitted to do so as well.

We believe that the leverage ratio should not reflect the additional capital deductions to Tier 1 capital under the advanced approach. For certain residual interests that are risk weighted under current capital rules there is no change in the amount of exposure or risk, merely a change in methodology from risk weighting to deduction. Additional deductions required under the A-IRB approach for securitizations or ALLL shortfalls would have negligible impact on actual leverage at the bank or holding company level. Hence we recommend that the leverage ratio be computed using Tier 1 capital prior to these deductions.

Question 11: *The agencies seek comment on what other information should be considered in deciding whether those overall capital goals have been achieved.*

Response 11: As we previously indicated, static point in time comparisons between Basel I and Basel II, either in the aggregate or for a particular portfolio, are not directly measuring the relationship of capital to risk. Thus, they do not provide a comprehensive picture of the extent to which the agencies' capital objectives have been achieved. We believe it is important to observe changes in risk management practices at Basel II banks and the extent to which Pillar 1 capital and actual capital vary with economic and credit conditions in the initial years of operation under the new capital framework.

Question 12: *The agencies are proposing to make 2008 the first possible year for a bank to conduct its parallel run and 2009-2011 the first possible years for the three transitional floor periods. The agencies seek comment on this proposed timetable for implementing the advanced approaches in the United States.*

Response 12: Please refer to our comments in Section III. B. We reiterate that we are opposed to an undue delay in final implementation.

B. Qualification (Q. 13-20)

Question 13: *A bank must assign each legal entity wholesale obligor to a single rating grade. Accordingly, if a single wholesale exposure of the bank to an obligor triggers the proposed rule's definition of default, all of the bank's wholesale exposures to that obligor are in default for risk-based capital purposes. In addition, a bank may not consider the value of collateral pledged to support a particular wholesale exposure (or any other exposure-specific characteristics) when assigning a rating to the obligor of the exposure, even in the context of nonrecourse loans and other loans underwritten primarily based on the operating income or cash flows from real estate collateral. A bank may, of course, consider all available financial information about the obligor— including, where applicable, the total operating income or cash flows from all of the obligor's projects or businesses— when assigning an obligor rating.*

The agencies seek comment on this aspect of the proposed rule and on any circumstances under which it would be appropriate to assign different obligor ratings to different exposures to the same obligor (for example, income-producing property lending or exposures involving transfer risk).

Response 13: The context for qualification of an internal risk rating system begins with an acknowledgement that when determining an obligor rating a bank should consider both quantitative and qualitative factors that could affect the obligor's default risk. As such, supervisory restrictions that serve to exclude certain qualitative factors, such as ownership and implied support by a parent of its subsidiary from the rating consideration will only lead to conflicts with internal practices. In addition, it will be difficult to validate ratings with imposed restrictions against assumed PDs using an analysis of outcomes.

In the same way, it should be recognized that different exposures to the same obligor, some involving transfer risk and some exempt from transfer risk could arguably be classified as exposures to two different economic entities, even though they may be the same legal entity. In the case of the transfer risk exposure, the sovereign inserts itself in place of the obligor and forces default, while where there is no transfer risk, the risk is that of the underlying obligor. For internal economic assessments, two "quasi obligors" are often created, one having a country risk rating overlay and one having a rating that is not directly affected by the transfer risk.

In the same way, creating a single obligor rating for multiple income producing properties where there are no guarantees on the part of the principal nor no cross defaults among the facilities tends to distort the risk assessment process. While a legal entity approach is a good starting point, it needs to be modified to take into account the assessment process of the likelihood of default and its consequences. It can be argued that for income producing property the amount of equity and therefore the value of the collateral pledged to the bank clearly affects the likelihood that the borrower will default on that property. With a substantial amount of equity value the borrower may continue to support the property even when it becomes troubled and as a consequence, if a default were to occur, the recovery may be greater. The same borrower could more easily walk away from a thinly capitalized project and possibly refer prospective tenants to the more heavily capitalized property. While theoretically, LGDs and PDs should be considered separately, the reality is that for individually collateralized exposures they are inevitably intertwined.

Question 14: *Under the proposed rule's definition of default, a bank's wholesale obligor would be in default if, for any credit exposure of the bank to the obligor, the bank has (i) placed the exposure on nonaccrual status consistent with the Call Report Instructions or the Thrift Financial Report and the Thrift Financial Report Instruction Manual; (ii) taken a full or partial charge-off or write-down on the exposure due to the distressed financial condition of the obligor; or (iii) incurred a credit-related loss of 5 percent or more of the exposure's initial carrying value in connection with the sale of the exposure or the transfer of the exposure to the held-for-sale, available-for-sale, trading account, or other reporting category. When a bank sells a set of wholesale exposures, the bank must examine the sale prices of the individual exposures contained in the set and evaluate whether a credit loss of 5 percent or more of the exposure's initial carrying value has occurred on any given exposure.*

The agencies seek comment on this proposed definition of default and on how well it captures substantially all of the circumstances under which a bank could experience a material credit-related economic loss on a wholesale exposure. In particular, the agencies seek comment on the appropriateness of the 5 percent credit loss threshold for exposures sold or transferred between reporting categories. The agencies also seek commenters' views on specific issues raised by applying different definitions of default in multiple national jurisdictions and on ways to minimize potential regulatory burden, including use of the definition of default in the Accord, keeping in mind that national bank supervisory authorities must adopt default definitions that are appropriate in light of national banking practices and conditions.

Response 14: As proposed, the definition of default leads to inconsistencies in determining the classification of a credit exposure for calculating its RWA and for building a reference database. To the extent that these definitions diverge from the international framework, this will not only be a burden on the reporting institution in maintaining two systems but the analytical process of relating capital requirements to credit conditions will be compromised.

Considering the sale of a loan at a discount as a default event has ramifications to an historical analysis of outcomes that would be included in the reference database. For example, a bank may be motivated to sell a portion of its loan at a discount if it had bought a total return swap and wished to match the two legs of the transaction. The bank would then need to flag such situations and effectively create a dual reference database - one for assessing economic PDs and the other for regulatory PDs. This duality would likely lead to further use case differences.

The definition of default also fails to consider the case where an obligor defaults on obligations due to other creditors but due to the strength of the structuring and collateral continues to make payment of principal and interest to the bank, even during bankruptcy, having been provided by the court with adequate protection. To ensure consistency in risk assessment, some banks will choose to assess the likelihood of default by the borrower to any creditor. A borrower exhibiting a high level of distress would then be rated poorly. The LGD assessment for a facility exhibiting such characteristics would be relatively low. Since the bank has a high assurance of continued payment it would not place the exposure in a non-accrual status. The treatment of this obligor and its LGD as part of an outcomes analysis results in a validation of the PD, in that it did "default" according to the bank's internal definition and that the associated LGD would have been zero.

This situation also arises in income producing property where the bank may have a well-secured first mortgage and there is a default on a second mortgage which cannot automatically cause a default on the first mortgage. The bank may choose to rate the obligor on the basis of a default on the second mortgage but continue to assess the LGD as quite low.

There is no objective basis for making the assumption that a 5% loss upon sale of a credit exposure is an appropriate standard for defining a default. To date, this benchmark has not been set in jurisdictions outside the United States. This may well lead to different definitions of default for the same asset under different regimes. In addition, even within the United States, one member of a banking syndicate may have decided to sell its loan at such a discount while another bank may have decided to retain this loan, leading to different capital requirements.

Question 15: *In light of the possibility of significantly increased loss rates at the subdivision level due to downturn conditions in the subdivision, the agencies seek comment on whether to require banks to determine economic downturn conditions at a more granular level than an entire wholesale or retail exposure subcategory in a national jurisdiction.*

Response 15: Requiring banks to provide downturn LGD estimates for subdivisions of entire rating categories, such as industries or regions, creates both estimation and implementation problems and further distances regulatory capital from economic capital practices. Assuming that systematic downturn conditions affect LGDs, it would be unusual for these to take place at all subdivision levels over the same time period. For example, while there may be peak LGD periods for both the telecommunications and for retailing industries, these could occur years apart. Selecting the worse of the LGDs for each of these subdivisions in an ASRF[42] capital formula violates basic portfolio theory and the recognition of diversification effects. Should the regulations specify a common timeframe such as a specific recession year that resulted in the highest overall LGD percentage for the bank as a whole, then one might very well discover some subdivision LGDs that were lower for that year than their average default-weighted LGDs.

For retail exposures, it is also unlikely that downturn conditions would be coincident across all subdivisions of products such as credit cards, mortgages and auto loans. However, as previously noted, application of downturn LGD at a subcategory or further subdivision level implies the unrealistic and unnecessarily conservative assumption that all subdivisions experience downturn conditions simultaneously. The diversification benefit due to timing should not be ignored by requiring downturn LGD at subdivision levels. In addition, reliably determining actual downturn effects at a more granular level is even more difficult, in part due to continual changes in product composition and underwriting.

Question 16: *The agencies seek comment on and supporting empirical analysis of (i) the proposed rule's definitions of LGD and ELGD; (ii) the proposed rule's overall approach to LGD estimation; (iii) the appropriateness of requiring a bank to produce credible and reliable internal estimates of LGD for all its wholesale and retail exposures as a precondition for using the advanced approaches; (iv) the appropriateness of*

[42] The asymptotic single risk factor (ASRF) approach is a simplified framework for determining regulatory capital charges for credit risk and has become an integral part of how credit risk capital requirements are to be determined under the second Basel Accord.

requiring all banks to use a supervisory mapping function, rather than internal estimates, for estimating LGDs, due to limited data availability and lack of industry experience with incorporating economic downturn conditions in LGD estimates; (v) the appropriateness of the proposed supervisory mapping function for translating ELGD into LGD for all portfolios of exposures and possible alternative supervisory mapping functions; (vi) exposures for which no mapping function would be appropriate; and (vii) exposures for which a more lenient (that is, producing a lower LGD for a given ELGD) or more strict (that is, producing a higher LGD for a given ELGD) mapping function may be appropriate (for example, residential mortgage exposures and HVCRE exposures).

Response 16: As acknowledged by the Basel Committee the evidence associated with "downturn LGDs" defined as "LGD" is unclear. While some studies[43] associated with public bond LGDs appear to show some level of correlations, these are based on measuring the trading price of such securities one month after default. Bank loan recovery processes operate very differently, with LGDs measured by discounting cash flows over the recovery period. In most cases these periods extend over several years, such that some recoveries may take place during expansionary parts of the credit cycle. Even when discounting is applied to these cash flows, evidence of the relationship between LGDs and default rates is quite mixed.[44]

The choice of the discount rate to be applied to bank loan recoveries may also be viewed as a function of the correlation between LGDs and systematic default rates. To the extent that correlations are demonstrated not to exist, one can argue that the discount rate can even approximate the risk free rate[45] plus some factor accounting for liquidity. Bank practice is to use a substantially more conservative rate for discounting purposes.

The relative degree of conservatism practiced by banks in measuring LGD should be explored as a counterpoint to incorporating a downturn LGD. To the extent that banks can demonstrate sufficient conservatism in their estimation processes, the need to apply a markup via a supervisory formula to obtain a downturn LGD may be obviated. Considerations of conservatism include choice of discount rates, analysis of collateral present at the time of default versus at origination and analysis of exposure reduction prior to default that tends to overstate the LGD percentages when applied to the non-defaulted segments of the portfolio.

The incorporation of a downturn LGD into the Basel RWA formula as a linear adjustment to RWA is a less than ideal approach to incorporating systematic correlation of LGD and PD effects. As described above, the degree to which this correlation affects

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[43] Altman, E.I., B.Brady, A. Resti, and A. Sironi, "The Link between Default and Recovery Rates: Theory, Empirical Evidence, and Implications." *Journal of Business*, November 2005.

[44] Araten, M., Jacobs, M., and Varshney, P. "Measuring LGD on Commercial Loans: An 18-Year Internal Study." *RMA Journal*, May 2004.

[45] Gordy, Michael. "Portfolio Credit Risk Modeling: A Regulatory Perspective on the State of the Art.", *Recent Advances in Credit Risk Research*, NYU Stern, New York, May 2004.

capital requirements is very much a function of portfolio composition and the degree to which downturn effects, if any, occur over the same time horizon for subdivisions of the portfolio. Banks may have sufficient historical data to determine the degree to which downturn LGDs are observable for different types of facilities. For example, empirical data may show that periods of recession do have impact on unsecured LGDs but not on secured LGDs. These effects could be quantified by measuring the correlation for these facilities. Banks with more advanced internal economic capital models may be able to incorporate both the systematic correlations of default rates and their effect on LGDs. The impact of downturn LGDs could thus be better estimated and, subject to supervisory review, be used to develop a bank specific "markup" to the Basel RWA formula.

For retail exposures, we question the need for a supervisory formula at the extremes for LGD. For mortgages, the 10% LGD floor would appear to cover the regulatory intent of incorporating downturn effects when there is the limited data history available to establish downturn LGDs. Credit Card LGDs, typically in the 90% range, should not require a supervisory mark-up.

We are also concerned that the mapping function would be applied as an implicit benchmark against which institution-derived downturn LGDs would be compared. The mapping function is not supported by empirical analysis, nor is it sensitive to portfolio-specific factors and thus would not be appropriate as a benchmark for internal estimates.

We strongly oppose a supervisory mapping requirement during the AIRB qualification period and beyond. Even if downturn LGD data is limited, internal estimates should be preferred to a supervisory formula when combined with appropriate judgment and conservatism.

Question 17: *The agencies seek comment on the extent to which ELGD or LGD estimates under the proposed rule would be pro-cyclical, particularly for longer-term secured exposures. The agencies also seek comment on alternative approaches to measuring ELGDs or LGDs that would address concerns regarding potential pro-cyclicality without imposing undue burden on banks.*

Response 17: Bank internal economic capital and the new Basel II regulatory capital frameworks are both designed to reflect current conditions of the credit cycle. To the extent that rating profiles and default likelihood increase and to the extent that LGDs are found to peak during such conditions, the proposed rule, as intended, would naturally be pro-cyclical. The requirement that LGD should be greater than ELGD during all periods encompassing a credit cycle, as illustrated by the application of a scalar, would exacerbate procyclicality.

To the extent that the supervisory process requires the establishment of a downturn LGD for longer-term secured exposures such as mortgages, despite the absence of supporting evidence, procyclicality would be increased. Updating LTV ratios during stress periods would likely show significant increases in values against modest decreases in loan levels through amortization. Assuming that other segmentation characteristics are unchanged,

these exposures would be placed in a higher RWA category and would increase procyclicality.

Question 18: *The agencies intend to limit recognition of the impact on ELGD and LGD of pre-default paydowns to certain types of exposures where the pattern is common, measurable, and especially significant, as with various types of asset-based lending. In addition, not all paydowns during the period prior to default warrant recognition as part of the recovery process. For example, a pre-default reduction in the outstanding amount on one exposure may simply reflect a refinancing by the obligor with the bank, with no reduction in the bank's total exposure to the obligor.*
The agencies seek comment on the feasibility of recognizing such pre-default changes in exposure in a way that is consistent with the safety and soundness objectives of this proposed rule. The agencies also seek comment on appropriate restrictions to place on any such recognition to ensure that the results are not counter to the objectives of this proposal to ensure adequate capital within a more risk-sensitive capital framework. In addition, the agencies seek comment on whether, for wholesale exposures, allowing ELGD and LGD to reflect anticipated future contractual paydowns prior to default may be inconsistent with the proposed rule's imposition of a one-year floor on M (for certain types of exposures) or may lead to some double-counting of the risk-mitigating benefits of shorter maturities for exposures not subject to this floor.

Response 18: Pre-default reductions in exposure are not only occasioned by contractual amortizations but also through the dynamic relationship between the bank and the borrower as the bank seeks to manage its risks. While the default horizon is set to one year, the incorporation of a maturity adjustment implicitly adjusts for risks that can take place over a period in excess of one year. To the extent that paydowns are triggered by financial covenants or by negotiations between the bank and the borrower, there is a reduction in risk, which needs to be recognized.

If it is determined that it may not be practical to specifically incorporate such reductions in the estimation of LGD and ELGD, the demonstrated evidence of such paydowns should be a consideration as part of a Pillar 2 review of the bank's overall conservatism in its estimation of LGDs, ELGDs and PDs.

Question 19: *The agencies solicit comment on all aspects of the proposed treatment of operational loss and, in particular, on (i) the appropriateness of the proposed definition of operational loss; (ii) whether the agencies should define operational loss in terms of the effect an operational loss event has on the bank's regulatory capital or should consider a broader definition based on economic capital concepts; and (iii) how the agencies should address the potential double-counting issue for premises and other fixed assets.*

Response 19: The definition of operational risk is consistent with general industry use for capture and benchmarking of operational losses. The existing definition should be retained without change. See also Section V on Specific Operational Risk Issues.

Question 20: *The agencies seek comment on the appropriateness of the 24-month and 30-day time frames for addressing the merger and acquisition transition situations advanced approaches banks may face.*

Response 20: A bank may need more than 30 days to formulate an implementation plan to allow for sufficient time for thorough review. Provided there is flexibility to extend the twenty-four months time frame under appropriate circumstances, particularly in light of conditions identified in the planning process, this may be sufficient to merge data feeds and calculators and complete a transition.

C. Calculation of capital and risk-weighted assets (Q. 21-33)

Question 21: *Commenters are encouraged to provide views on the proposed adjustments to the components of the risk-based capital numerator as described below. Commenters also may provide views on numerator-related issues that they believe would be useful to the agencies' consideration of the proposed rule.*

Response 21: We find the proposed adjustments to the elements of Tier 1 and Tier 2 capital discussed in this section of the NPR are consistent with the Accord with the following exception: minimum capital required for insurance underwriting subsidiaries by their functional regulator must be deducted from Tier 1, whereas Par. 30 and 37 of the Accord indicate this deduction be made 50% from Tier 1 and 50% from Tier 2. We oppose making this deduction 100% from Tier 1.

The proposed rule would require the use of the Basel II definition of Tier 1 Capital for the purpose of calculating the leverage ratio, even during the transition period. Since risk-based capital deductions should have no impact on leverage for well-capitalized banks, we believe that the leverage ratio for Basel II banks should not be penalized and the numerator for leverage ratio purposes should be Tier 1 capital prior to capital deductions.

Question 22: *For defaulted exposures, ECL is based on accounting measures of credit loss incorporated into a bank's charge-off and reserving practices. The agencies believe that, for defaulted exposures, any difference between a bank's best estimate of economic losses and its impairment estimate for ALLL purposes is likely to be small. As a result, the agencies are proposing to use a bank's ALLL impairment estimate in the determination of ECL for defaulted exposures to reduce implementation burden for banks. The agencies recognize that this proposed treatment would require a bank to specify how much of its ALLL is attributable to defaulted exposures, and that a bank still would need to capture all material economic losses on defaulted exposures when building its databases for estimating ELGDs and LGDs for non-defaulted exposures.*

The agencies seek comment on the proposed ECL approach for defaulted exposures as well as on an alternative treatment, under which ECL for a defaulted exposure would be calculated as the bank's current carrying value of the exposure multiplied by the bank's best estimate of the expected economic loss rate associated with the exposure (measured relative to the current carrying value), that would be more consistent with the proposed

treatment of ECL for non-defaulted exposures. The agencies also seek comment on whether these two approaches would likely produce materially different ECL estimates for defaulted exposures. In addition, the agencies seek comment on the appropriate measure of ECL for assets held at fair value with gains and losses flowing through earnings.

Response 22: We support the proposed approach of using a bank's ALLL impairment estimate to determine ECL for defaulted exposures. No material differences are expected between the proposed approach and the alternative treatment of using the current carrying value multiplied by the bank's best estimate of economic loss as both approaches are based on the same input parameters.

Question 23: *For BHCs with consolidated insurance underwriting subsidiaries that are functionally regulated... the following treatment would apply. The assets and liabilities of the subsidiary would be consolidated for purposes of determining the BHC's risk-weighted assets. However, the BHC must deduct from Tier 1 capital an amount equal to the insurance underwriting subsidiary's minimum regulatory capital requirement as determined by its functional (or equivalent) regulator. This approach is different from the Accord, which broadly endorses a deconsolidation and deduction approach for insurance subsidiaries. The Board believes a full deconsolidation and deduction approach does not fully capture the risk in insurance underwriting subsidiaries at the consolidated BHC level and, thus, has proposed the consolidation and deduction approach described above.*

The Board seeks comment on this proposed treatment and in particular on how a minimum insurance regulatory capital proxy for Tier 1 deduction purposes should be determined for insurance underwriting subsidiaries that are not subject to U.S. functional regulation.

Response 23: We agree with the logic of excluding insurance assets and deducting required regulatory capital for separately regulated insurance underwriting activities. If insurance assets were so excluded, we would agree with a deduction of minimum capital required by insurance solvency regulation and with the inclusion of any surplus capital for bank capital adequacy purposes. However, the NPR includes insurance assets in risk weighting. We oppose risk weighting insurance assets because it represents a double-counting of capital requirements, once for insurance regulation and again for banking regulation. Requiring additional capital, particularly for higher risk assets where these assets are closely monitored under insurance regulation, represents an instance of dual regulation that should be eliminated. We also oppose deducting the full amount of insurance-related capital from Tier 1, since par. 37 of the Accord indicates the deduction to be 50% from Tier 1 and 50% from Tier 2.

Question 24*: The agencies seek comment on how to strike the appropriate balance between the enhanced risk sensitivity and marginally higher risk-based capital requirements obtained by separating high volatility commercial real estate (HVCRE)*

exposures from other wholesale exposures and the additional complexity the separation entails.

Response 24: Applying a separate formula does not necessarily resolve the question of striking an appropriate balance between enhanced risk sensitivity and marginally higher risk-based capital requirements obtained by separating HVCRE exposures. The assumption behind this separation is that HVCRE exposures have common systematic risk. However, this assumption may not hold when one considers a portfolio of different property types, regions or even countries. A bank's HVCRE portfolio could be very well-diversified across property types, locations, etc. We recommend that it would be more appropriate to address the unique risk characteristics of these types of exposures under Pillar 2 in terms of concentration risk management.

***Question 25**: In contrast to the Accord, the agencies are not including in this proposed rule an adjustment that would result in a lower risk weight for a loan to a small- and medium-size enterprise (SME) that has the same risk parameter values as a loan to a larger firm. The agencies are not aware of compelling evidence that smaller firms with the same PD and LGD as larger firms are subject to less systematic risk.*
The agencies request comment and supporting evidence on the consistency of the proposed treatment with the underlying riskiness of SME portfolios. Further, the agencies request comment on any competitive issues that this aspect of the proposed rule may cause for U.S. banks.

Response 25: Please refer to our comment in Section IV. F. As stated earlier, while we acknowledge that the NPR may be departing from the Accord out of concern that the treatment of SME capital may have been overly aggressive, we recommend that either the rule be amended to conform to the Accord or the agencies reconsider this issue in consultation with the Basel Committee.

***Question 26:** The agencies request comment on the appropriate treatment of tranched exposures to a mixed pool of financial and non-financial underlying exposures. The agencies specifically are interested in the views of commenter as to whether the requirement that all or substantially all of the underlying exposures of a securitization be financial exposures should be softened to require only that some lesser portion of the underlying exposures be financial exposures.*

Response 26: The trend in the securitization market is to move into new asset classes. Business groups are always looking for new asset classes to securitize. These include both financial and non-financial assets such as trademarks, patents, copyrights, revenue from infrastructure projects, rental cars and entertainment royalties from movies, concerts and television. As the market for securitization expands so should the product types that are captured under the Basel II rules for securitization. More transactions may include a broader spectrum of underlying asset types and therefore the allowable portion of non-financial assets that could be included in a transaction should be increased.

As the market continues to grow, the Basel II rules should be sufficiently flexible so that they can accommodate growth in the market and include a range of new underlying assets types for which external ratings may not yet be available. Our recommendations follow for the two rating circumstances described below.

Externally Rated Transactions

In cases where the securities are externally rated we propose to apply the RBA treatment to those securities and the inferred approach to any associated liquidity facilities. Many new transactions with non-financial underlying asset types are funded in the term ABS market where the securities issued by the transaction will always have an external rating. These meet the criteria for the RBA.

No External or Internal Ratings

Certain ABS transactions are often paired with an ABCP conduit that provides capacity for additional growth or seasonal funding. The securities issued and the underlying assets are unrated. Specific rating agency criteria exist. In order to issue ABCP in the market the paper issued by these transactions must receive a short term rating from the agencies. We propose that the "Exceptions to the General Hierarchy of Approaches" should be further expanded to include the IAA for non-financial underlying assets that meet the rating agency criteria for the underlying asset type being securitized.

Question 27: *The agencies seek commenters' perspectives on other loss types for which the boundary between credit and operational risk should be evaluated further (for example, with respect to losses on HELOCs).*

Response 27: We do not find current industry standards for fraud loss management for HELOCs to be comparable to those in the card industry. While we recognize the value in the leveraging of such discipline, this is not standard practice today. As a result, we propose at this time to treat fraud loss in HELOCs consistently with the treatment for other mortgages, rather than cards.

Question 28: *The agencies generally seek comment on the proposed treatment of the boundaries between credit, operational, and market risk.*

Response 28: We believe boundary issues between credit and operational risk should be addressed in a straightforward manner that does not introduce unnecessary ambiguity or implementation challenges. To this end we believe the accounting rules governing credit losses should serve as the guiding principle. If a loss is treated as a credit loss for financial statement purposes, i.e. it is charged against the Allowance for Loan and Lease Losses (ALLL), then that loss should also be treated as credit risk for regulatory capital purposes. Conversely, if the loss is ineligible for loss reserve purposes, it should then be captured as an operational risk loss for regulatory purposes. Additionally, financial institutions should be encouraged to track operational risk issues and events above a self-defined cost-benefit threshold that manifest themselves as credit losses even if they are not included into the operational risk capital computation; tracking such events for risk management purposes would be beneficial.

For additional comments on the boundary with market risk, please refer to our discussion of "non-covered positions" in our January 23, 2006 comment letter in response to the Market Risk NPR.

Question 29: *The agencies are proposing to exclude tranched guarantees that apply only to an individual retail exposure from the securitization framework. An important result of this exclusion is that, in contrast to the treatment of wholesale exposures, a bank may recognize recoveries from both an obligor and a guarantor for purposes of estimating the ELGD and LGD for certain retail exposures.*
The agencies seek comment on this approach to tranched guarantees on retail exposures and on alternative approaches that could more appropriately reflect the risk mitigating effect of such guarantees while addressing the agencies' concerns about counterparty credit risk and correlation between the credit quality of an obligor and a guarantor.

Response 29: Tranched guarantees applicable to specific retail exposures are essentially limited to mortgage insurance. Banks employ mortgage insurance (MI) in their mortgage businesses and appropriately include MI proceeds in LGD estimates. Banks may secure similar guarantees, whether sovereign or private, for education loans. This type of risk mitigation should be encouraged by the regulatory framework. As such, we agree with the proposed treatment differential in the NPR for tranched guarantees on individual retail exposures as opposed to that employed in the securitization framework.

Question 30: *If a bank is not able to estimate PD, ELGD, and LGD for a segment of eligible margin loans, the bank may apply a 300 percent risk weight to the EAD of the segment. The agencies seek comment on wholesale and retail exposure types for which banks are not able to calculate PD, ELGD, and LGD and on what an appropriate risk-based capital treatment for such exposures might be.*

Response 30: Historical loss data, which combines PDs, LGDs and EADs and judgmental considerations, should be the basis for the assignment and validation of these parameters, rather than an arbitrary 300% risk weight. Where the parameters cannot be estimated, a conservative estimate based on all available information is preferable to a 300% risk weight.

Margin lending borrowers include entities across the spectrum of bank customers: individuals, corporations, trusts, partnerships, etc. In the event of borrower bankruptcy, lenders will seek to sell the collateral to repay the loan. The relevant measure of risk for much margin lending is the relationship between collateral and loan values rather than the underlying borrower default risk. The supporting data to characterize "defaults" is weak in that one cannot "observe" a borrower default as a distinct event. Collateral is liquidated at the time some or all of a portion of loan is repaid. Most of these cases are clearly not defaults. Borrowers allow lenders to sell a portion of the collateral to satisfy a margin requirement and often choose to do so when securities in their portfolio are performing poorly. Default risk for margin loans is related to collateral characteristics and margining policies.

Question 31: *The agencies seek comment on the appropriateness of permitting a bank to consider prepayments when estimating maturity (M) and on the feasibility and advisability of using discounted (rather than undiscounted) cash flows as the basis for estimating M.*

Response 31: We support the proposal to consider prepayments when estimating M. One suggested approach is to consider historical prepayment data by credit quality grade and use conservative estimates based on historical data to account for prepayments in the M determination.

Question 32: *The general risk-based capital rules assign 50 and 100 percent risk weights to certain one- to four-family residential pre-sold construction loans and multifamily residential loans. The agencies adopted these provisions as a result of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRRI Act). The RTCRRI Act mandates that each agency provide in its capital regulations a 50 percent risk weight for certain one- to four-family residential pre-sold construction loans and multifamily residential loans that meet specific statutory criteria. The agencies seek comment on whether the agencies should impose the following underwriting criteria as additional requirements for a Basel II bank to qualify for the statutory 50 percent risk weight for a particular mortgage loan: (i) that the bank has an IRB risk measurement and management system in place that assesses the PD and LGD of prospective residential mortgage exposures; and (ii) that the bank's IRB system generates a 50 percent risk weight for the loan under the IRB risk-based capital formulas.*

Response 32: The application of dual standards by combining the higher of a statutory 50% risk weight and the IRB risk weight is inconsistent with the intent of a risk-based regime. Longer term, we believe a change in RTCRRIA to conform to the Basel standard would appropriately resolve the conflict between Basel II and FDICIA on the one hand and RTCRRIA on the other.

Question 33*: The agencies seek comment on all aspects of the proposed treatment of one-to-four family residential pre-sold construction loans and multifamily residential loans.*

Response 33: Please see our responses to Q. 1, 2 and 32 above.

D. Credit risk mitigation (Q. 34-44)

Question 34*: For purposes of determining EAD for counterparty credit risk and recognizing collateral mitigating that risk, the proposed rule allows banks to take into account only financial collateral, which, by definition, does not include debt securities that have an external rating lower than one rating category below investment grade. The agencies invite comment on the extent to which lower-rated debt securities or other securities that do not meet the definition of financial collateral are used in these transactions and on the CRM value of such securities.*

Response 34: Under standard market practices, banks will accept collateral of all types of credit quality but will impose more stringent internal haircuts that are derived from VaR-type methodologies on the lower-rated securities. This is particularly relevant for repo-style transactions. In addition, banks may collateralize these transactions with other types of financial assets such as mortgage loans and letters of credit, which currently do not meet the NPR definition of "financial collateral." We believe that restrictions on collateral recognition will create further misalignment between industry and regulatory practices. Therefore, we recommend that supervisors allow banks to rely upon their internal collateral recognition policies, subject to regulatory oversight.

Question 35: *The agencies recognize that criterion (iii)*[46] *may pose challenges for certain transactions that would not be eligible for certain exemptions from bankruptcy or receivership laws because the counterparty—for example, a sovereign entity or a pension fund—is not subject to such laws. The agencies seek comment on ways this criterion could be crafted to accommodate such transactions when justified on prudential grounds, while ensuring that the requirements in criterion (iii) are met for transactions that are eligible for those exemptions.*

Response 35: We agree with the agencies that for certain counterparty types, it is challenging to demonstrate the netting enforceability required for Basel II calculations. Therefore we recommend that for counterparties which are not subject to bankruptcy or receivership laws in relevant jurisdictions, the criterion be modified to state the following: "the bank has conducted sufficient legal review to reach a well-founded conclusion that:

1. The repo-style transaction agreement executed in connection with the transaction provides the bank the right to accelerate, terminate and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of counterparty default; and
2. Under the law governing the agreement, its rights under the agreement are legal, valid, binding and enforceable."

Question 36*: The agencies seek comment on the appropriateness of requiring that a bank have a perfected, first priority security interest, or the legal equivalent thereof, in the definition of financial collateral.*

Response 36: This requirement is appropriate.

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[46] (iii) The transaction is executed under an agreement that provides the bank the right to accelerate, terminate, and closeout the transaction on a net basis and to liquidate or set off collateral promptly upon an event of default (including upon an event of bankruptcy, insolvency, or similar proceeding) of the counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions.

***Question 37**: The agencies recognize that this (the "CUSIP-based" approach)[47] is a conservative approach and seek comment on other approaches to consider in determining a given security for purposes of the collateral haircut approach.*

Response 37: We consider the "CUSIP-based" approach outlined in the NPR to determine a given security's haircut a reasonable approach. However we wish to call supervisors' attention to the NPR requirement that for below investment grade debt securities and equity securities, banks are required to calculate a security-specific internally estimated haircut instead of calculating haircuts by security category. We deem our internal benchmark categories used for all types of securities to be sufficiently granular and representative of the volatility characteristics of the securities which map to a given benchmark category. Furthermore, we question why banks would be required to diverge from internal risk management practices where benchmark securities are used for all securities to calculate appropriate haircuts.

***Question 38**: The agencies seek comment on methods banks would use to ensure enforceability of single product OTC derivative netting agreements in the absence of an explicit written legal opinion requirement.*

Response 38: Current internal practices require that we always obtain a written legal opinion in order to ensure the enforceability for OTC Derivatives netting arrangements. In the event an external legal opinion cannot be obtained, we will, at a minimum, obtain an internal legal opinion.

***Question 39**: The agencies request comment on all aspect of the effective EPE approach to counterparty credit risk, and in particular on the appropriateness of the monotonically increasing effective EE function, the alpha constant of 1.4, and the floor on internal estimates of alpha of 1.2.*

Response 39: The introduction of the Internal Models methodology as an alternative method to calculate EAD for counterparty credit exposure is greatly welcomed. However the effective EPE approach outlined in the NPR would benefit from certain refinements as stated below.

Effective EE

We do not support the use of Effective EE as a measure to account for roll-over of short-dated exposures. Banks generally have internal limits monitoring and active risk management to prevent surprise defaults and we believe that supervisors should address a bank's ability to account for roll-over risk under the Pillar 2 supervisory review process. The current proposal to impose a broad formula-based floor to account for the existence of roll-over effects would likely produce imprecise results.

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[47] For purposes of the collateral haircut approach, a given security would include, for example, all securities with a single CUSIP number and would not include securities with different CUSIP numbers, even if issued by the same issuer with the same maturity date.

Moreover if banks are required to calculate Effective EE, the calculations should be performed at the counterparty level because rollover risk is typically not considered at the "netting set" level.

Alpha

Our internal models demonstrate that the 1.2 floor for internal alpha estimates is very conservative. We do not understand the supervisors' rationale for imposing such a high floor.

Application of collateral

The NPR requires that under the internal models methodology EAD must be estimated at the level of 'netting set.' Our internal model currently calculates average exposure at the netting set level but applies collateral at the collateral contract level, which is typically the counterparty level. When this application of collateral is performed across netting sets, exposure for all netting sets will have been floored at zero so there will be no "netting" benefit from applying collateral across netting sets. For implementation ease, we would like to continue with our current methodology of applying collateral and reporting EAD at the collateral contract/counterparty level. Allocating collateral back to the netting set level seems arbitrary and has no impact on the overall EAD results.

In addition, as stated as a qualifying criterion for a bank to use the internal models methodology, the NPR requires that "*the bank must measure and manage current exposures gross and net of collateral held, where appropriate. The bank must estimate expected exposures for OTC derivative contracts both with and without the effect of collateral agreements.*"[48] Running our internal exposure model on a routine basis with and without the effect of collateral agreements does not yield meaningful results and is not consistent with our internal risk management processes. Our view is that a bank's internal model should have the capability to measure current and expected exposures gross and net of collateral, and this capability can be demonstrated to the supervisors on a ad-hoc basis. On a routine basis, however, where banks can demonstrate legal confidence in collateral enforceability, banks should be required to estimate current and expected exposure only net of collateral.

***Question 40**: The agencies request comment on the appropriateness of these criteria in determining whether the risk mitigation effects of a credit derivative should be recognized for risk-based capital purposes.*[49]

Response 40: The above-mentioned criteria are appropriate.

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[48] Federal Register, Vol. 71, No. 185, September 25, 2006: p. 55874.

[49] The referenced criteria include requirements that the credit derivative contract has been confirmed by all parties and that it clearly articulates certain credit events, settlement terms and conditions, and the parties responsible for determining when a credit event has occurred. In addition, the criteria specify the accounting treatment to be employed when using total return swaps for risk mitigation purposes under risk-based capital calculations.

***Question 41**: The agencies are interested in the views of commenters as to whether and how the agencies should address these and other similar situations in which multiple credit risk mitigants cover a single exposure.*

Response 41: With respect to multiple credit risk mitigants covering a single exposure, we recommend that the agencies allow recognition of the lower risk of joint default particularly in these situations. The bank will experience losses only if the reference obligor and all of the protection providers associated with the multiple credit risk mitigants default simultaneously. This results in a lower risk to the bank than if no CRM or a single CRM was obtained for the underlying exposure.

***Question 42:** The agencies seek comment on this alternative approach's definition of eligible retail guarantee and treatment for eligible retail guarantees, and on whether the agencies should provide similar treatment for any other forms of wholesale credit insurance or guarantees on retail exposures, such as student loans, if the agencies adopt this approach.*
Under this alternative, an eligible retail guarantee would be an eligible guarantee that applies to a single retail exposure and is:
(i) PMI issued by an insurance company that (A) has issued a senior unsecured long-term debt security without credit enhancement that has an applicable external rating in one of the two highest investment grade rating categories or (B) has a claims payment ability that is rated in one of the two highest rating categories by an NRSRO; or
(ii) issued by a sovereign entity or a political subdivision of a sovereign entity.

Response 42: The approach to defining eligible corporate guarantors, such as mortgage insurance entities that would be applied to individual retail exposures, is reasonable. PD estimation for the particular segment would continue without taking into consideration the effect of the guarantee, while LGDs would reflect the benefit of the guarantee.

***Question 43:** The agencies seek comment on the types of non-eligible retail guarantees banks obtain and the extent to which banks obtain credit risk mitigation in the form of non-eligible retail guarantees.*

Response 43: To the extent that guarantors are deemed not eligible according to the above criteria, we suggest that PD estimation should continue to be based on the segment's default characteristics. With respect to the manner in which LGDs are adjusted to reflect the benefit of these non-eligible guarantors, we suggest that the basis of these LGDs should be evaluated as part of the supervisory process and not be subject to a floor.

***Question 44:** (A second alternative) would permit a bank to recognize the credit risk mitigation benefits of all eligible guarantees (whether eligible retail guarantees or not) that cover retail exposures by adjusting its estimates of ELGD and LGD for the relevant segments, but would subject a bank's risk-based capital requirement for a segment of retail exposures that are covered by one or more non-eligible retail guarantees to a floor on risk-based capital requirements of between 2 percent and 6 percent on such a segment*

of retail exposures. The agencies seek comment on both of these alternative approaches to guarantees that cover retail exposures. The agencies also invite comment on other possible prudential treatments for such guarantees.

Response 44: We oppose floors whenever there are more appropriately risk sensitive or flexible solutions. Without sufficient empirical grounding, the level of such a floor would be arbitrary.

E. Securitization (Q. 45-54)

Question 45: *The agencies have distinguished the use of the Rating Based Approach (RBA) between banks as originators and investors. An originating bank must use the RBA if its retained securitization exposure has at least two external ratings or an inferred rating based on at least* ***two*** *external ratings; an investing bank must use the RBA if its securitization exposure has* ***one*** *or more external or inferred ratings.*

The agencies seek comment on this differential treatment of originating banks and investing banks and on alternative mechanisms that could be employed to ensure the reliability of external and inferred ratings of non-traded securitization exposures retained by originating banks.

Response 45: We believe that both originators and investors should be able to rely on a single external rating. When the originator retains securitization exposure it should not be required to have two external ratings. This would be consistent with the treatment in the Accord. NRSROs have developed specific published criteria which are enforced by market discipline. The criteria clearly identify the requirements for attaining a specific rating. The market relies on these criteria and expects any single NRSRO rating to conform to the published rating criteria.

Question 46: *Under the proposed rule, a bank also must use the RBA for securitization exposures with an inferred rating. Similar to the general risk-based capital rules, an unrated securitization exposure would have an inferred rating if another securitization exposure associated with the securitization transaction (that is, issued by the same issuer and backed by the same underlying exposures) has an external rating and the rated securitization exposure (i) is subordinated in all respects to the unrated securitization exposure; (ii) does not benefit from any credit enhancement that is not available to the unrated securitization exposure; and (iii) has an effective remaining maturity that is equal to or longer than the unrated securitization exposure. Under the RBA, securitization exposures with an inferred rating are treated the same as securitization exposures with an identical external rating.* [50]

The agencies seek comment on whether they should consider other bases for inferring a rating for an unrated securitization position, such as using an applicable credit rating on outstanding long-term debt of the issuer or guarantor of the securitization exposure.

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[50] Federal Register, Vol. 71. No. 185, September 25. 2006: p. 55884.

Response 46: We believe that the Inferred Approach used to determine a rating for an unrated securitization exposure is the appropriate methodology to identify the rating for this type of exposure. During the past two years we have reviewed numerous transactions to identify how they should be treated. We have determined that most unrated exposures are either senior (AA or better) or equity. If the inferred rating is AA or AAA then that rating is almost always better than the long-term debt rating of the issuer or guarantor.

The unrated exposures are often liquidity facilities to CDOs. The liquidity facilities, which are usually available for funding mismatches, are generally senior to the AAA notes issued by the transaction. The inferred rating should continue to be based on the tranche that is directly subordinate to the tranche under review.

Question 47: *Seniority*
The agencies seek comment on the appropriateness of basing the risk-based capital requirement for a securitization exposure under the RBA on the seniority level of the exposure.

Response 47: We agree with the agencies' requirement to include the seniority level of the exposure along with maturity, rating and granularity as the appropriate method to determine the risk weight.

Question 48*: Granularity*
The agencies seek comment on how well this approach captures the most important risk factors for securitization exposures of varying degrees of seniority and granularity.

Response 48: Diversification is the core tenet of a securitization transaction. Many of the models that the rating agencies use to value a securitization exposure include granularity as a component of their approach. Therefore, we agree with the agencies' requirement to include granularity as a parameter that should be used to determine the risk weights.

Question 49: *Re-securitization Number of Underlying Assets*
The agencies seek comment on suggested alternative approaches for determining the N of a re-securitization.

Response 49: Holders of a re-securitization should be allowed to "look-through" the securitization tranches being re-securitized to determine "N", provided that they have information regarding the underlying exposures on an ongoing basis. Before "N" can be calculated, exposures to the same obligor must be summed to avoid double counting.

Question 50: *Eligible Disruption Liquidity Facilities*
The version of the SFA contained in the Accord provides a more favorable capital treatment for eligible disruption liquidity facilities than for other securitization exposures. Under the Accord, an eligible disruption liquidity facility is a liquidity facility that supports an ABCP program and that (i) is subject to an asset quality test that precludes funding of underlying exposures that are in default; (ii) can be used to fund

only those exposures that have an investment grade external rating at the time of funding, if the underlying exposures that the facility must fund against are externally rated exposures at the time that the exposures are sold to the program; and (iii) may only be drawn in the event of a general market disruption. Under the Accord, a bank that uses the SFA to compute its risk-based capital requirement for an eligible disruption liquidity facility may multiply the facility's SFA-determined risk weight by 20 percent. [51]

The agencies have not included this concept in the proposed rule but seek comment on the prevalence of eligible disruption liquidity facilities and a bank's expected use of the SFA to calculate risk-based capital requirements for such facilities.

Response 50: We would suggest that program-wide liquidity facilities, such as market disruption liquidity facilities, be treated under the rules for overlapping facilities. It would not be practical to calculate the RWA using the SFA for an eligible disruption liquidity facility. In order to calculate the SFA information regarding the underlying assets would have to be known at all times. Based on the volume of assets in a conduit it would not be practical to track this information for the SFA calculation.

Question 51:
Under the proposed rule a bank is not required to hold regulatory capital against the investors' interest if early amortization is solely triggered by events not related to the performance of the underlying exposures or the originating bank, such as material changes in tax laws or regulation. Under the Accord, a bank is also not required to hold regulatory capital against the investors' interest if (i) the securitization has a replenishment structure in which the individual underlying exposures do not revolve and the early amortization ends the ability of the originating bank to add new underlying exposures to the securitization; (ii) the securitization involves revolving assets and contains early amortization features that mimic term structures (that is, where the risk of the underlying exposures does not return to the originating bank); or (iii) investors in the securitization remain fully exposed to future draws by borrowers on the underlying exposures even after the occurrence of early amortization.[52]

The agencies seek comment on the appropriateness of these additional exemptions in the U.S. markets for revolving securitizations.

Response 51: In general, we do not believe that the structures currently used in the card securitization market will qualify under these exemptions. We also believe that the structural changes required to meet these exemptions are either unworkable for revolving assets or will increase the cost of securitization financing to a level that makes revolving asset securitization a less attractive source of funding and liquidity. For example, exemption (ii) would require that we divide and account for a customer's balance in two components: (1) the balance existing at the early am date (i.e., the balance owned by the trust) and (2) any future balance that occurs after the early am date (i.e., the balance owned by the bank). Implementing this type of functionality would be time consuming

[51] Federal Register, Vol. 71, No. 185, September 25, 2006: p. 55890.
[52] Federal Register, Vol. 71, No. 185, September 25, 2006: p. 55893.

and expensive for credit card banks. We also believe that a structure that meets these exemptions would require higher credit enhancement levels than those necessary under current early amortization provisions. This will drive up the blended cost of revolving securitization thereby increasing the bank's cost of funds and making this source of funding less attractive relative to other funding options.

Question 52: *The agencies solicit comment on the distinction between controlled and non-controlled early amortization provisions and on the extent to which banks use controlled early amortization provisions. The agencies also invite comment on the proposed definition of a controlled early amortization provision, including in particular the 18-month period set forth above.*

Response 52: We are not aware of any U.S. credit card securitizations utilizing transaction structures that would meet all of the criteria required to qualify for the controlled early amortization provisions. Current structures do not meet the condition imposed by condition (ii) (as referred to above in Questions # 51) as the investor allocation of principal is fixed at the early amortization date. Changing this feature to a pro rata allocation during the early amortization period will likely increase the credit enhancement required in current credit card securitization structures. In addition, most transactions do not meet the amortization period and repayment schedule criteria (iii) and (iv) for controlled early amortization.[53] Therefore, modifying the structure to meet these conditions would also increase the required credit enhancement and drive up the blended cost of securitization.

The current market structure for early amortization facilitates a rapid payout of the investor interest. This feature, which reduces the required amount of credit enhancement under all rating agency analyses, is a currently accepted market standard contributing to the efficiency of credit card securitization structures. We would suggest that a less disruptive solution would be to evaluate an originating bank using only condition (i); *The originating bank has appropriate policies and procedures to ensure that it has sufficient capital and liquidity available in the event of an early amortization.* A bank meeting this condition should not be required to hold additional capital against its sold investor interests. However, at a minimum, it should be able to use the more advantageous CCF for a controlled early amortization method while other institutions would follow the formula for a non-controlled mechanism. In this way, the current market standard for early amortization could be preserved for banks with sufficient backup liquidity.

Question 53*: The agencies seek comment on the appropriateness of the 4.5 percent excess spread trapping point and on other types and levels of early amortization triggers used in securitizations of revolving retail exposures that should be considered by the agencies.*

Response 53: We think it is appropriate to review the purpose of the excess spread trapping mechanism in the typical "AAA", "A" and "BBB"-rated bond structure currently used in credit card securitization transactions. While the AAA-rated and A-

[53] Federal Register, Vol. 71, No. 185, September 25, 2006: p. 55894.

rated bonds are credit enhanced by the BBB-rated bonds, the BBB bondholder's only protection is provided by the trust's excess spread. If the excess spread were to decline or go to zero the BBB-rated bondholder has no additional protection available against losses. The rating agencies recognized this in the beginning of the credit card securitization market and would not assign an investment grade (e.g., BBB rating) to the bonds unless a sufficient amount of excess spread was trapped in a declining excess spread scenario[54]. When these structures were developed in the early 1990's there was little history regarding a "normal" level of excess spread and what volatility might be expected. Absent this history the rating agencies coalesced around a 4.5 % level of excess spread as an acceptable threshold for when excess spread should be trapped. Many transactions continue to use a 4.5% trapping level but it is perhaps more out of market convention than grounded in analytics.

We would propose that any dynamic credit conversion factor be based on the actual characteristics of the portfolio being securitized. Instead of relying on a 4.5% fixed trapping point approach we would suggest a methodology that considers the historical three month average excess spread and volatility of excess spread for each individual master trust. This approach is theoretically consistent with other methodologies contained in Basel II. In cases where master trusts are new or have limited history an analysis of the issuer's on balance sheet or managed portfolio could provide the statistics for a dynamic credit conversion factor. In cases where this information is not available we would support the use of a fixed trapping point.

We believe this dynamic, statistically based approach, achieves the goal of increasing a bank's capital needs when the probability of early amortization is rising but could eliminate unnecessary increases in capital caused by a fixed trapping point when excess spread changes are within normal ranges.

Question 54: *The agencies seek comment on and supporting empirical analysis of the appropriateness of a more simple alternative approach that would impose at all times a flat CCF on the entire investors' interest of a revolving securitization with a controlled early amortization provision, and on what an appropriate level of such a CCF would be (for example, 10 or 20 percent).*

Response 54: Conceptually, we feel that the requirement to hold additional capital for the investor interest in advance of an actual early amortization is unnecessary. Over the past 15 years, the performance of credit card securitization master trusts has demonstrated that the probability of early amortization is very low. As a result we would not support an approach where banks are required at all times to maintain capital against the assets sold in a credit card securitization. We would also reiterate our comments regarding the lack of controlled amortization structures in the current card securitization market and the practical difficulties with adopting this structure in the future. Therefore, we would oppose a flat CCF.

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[54] Excess spread trapped and held in the reserve account at the trustee is only available as credit enhancement for the BBB tranche of a credit card securitization. Said another way, it does not act as additional credit enhancement available to the AAA and A tranches.

F. Equity exposures (Q. 55-59)

Question 55: *The proposed rule defines a publicly traded equity exposure as an equity exposure traded on (i) any exchange registered with the SEC as a national securities exchange under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); (ii) NASDAQ; or (iii) any non-U.S.-based securities exchange that is registered with, or approved by, a national securities regulatory authority, provided that there is a liquid, two-way market for the exposure (that is, there are enough bona fide offers to buy and sell so that a sales price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined promptly and a trade can be settled at such a price within five business days). The agencies seek comment on this definition.*

Response 55: The Accord defines a publicly traded holding more simply, as any equity security traded on a recognized security exchange. For non-U.S.-based securities exchanges, we believe registration or approval by the national securities regulatory authority should suffice for this definition.

Question 56: *The agencies seek comment on the approach to adjusted carrying value for the off-balance sheet component of equity exposures and on alternative approaches that may better capture the market risk of such exposures.*

Response 56: Under the proposed rule, carrying value is adjusted to subtract unrealized gains on available-for-sale equity securities that are reflected on the balance sheet. The rationale for this is that these unrealized gains are deducted from Tier 1 capital. We support this adjustment to carrying value to prevent a double counting of capital requirements, i.e. requiring regulatory capital for unrealized gains already deducted from Tier 1.

Question 57: *The agencies seek comment on the proposed rule's requirements for IMA qualification, including in particular the proposed rule's use of a 99.0 percent, quarterly returns standard.*

Response 57: The NPR "either/or" requirements limiting use of the two market-based approaches are too restrictive. A firm must choose (1) one of either the internal model approach (IMA) or the simple risk weight approach (SRWA) for <u>all</u> equity exposures, or (2) The IMA approach for <u>all publicly traded</u> equity exposures and the SRWA for <u>all non-publicly traded</u> equity exposures.

We recommend that in order to provide a greater incentive for firms to qualify for internal model approach (IMA), firms should be permitted to develop different market-based approaches for different portfolios, provided portfolio treatment choices are consistent with internal risk management. We believe supervisory discretion for this more flexible approach is permitted under paragraph 348 of the Accord. Banks should

also be permitted to recognize guarantees on an equity position under both the market based approaches, consistent with the Accord.

Question 58: *Under the IMA approach, the risk-weighted asset amount would be subject to a floor of 200 percent for publicly traded equity exposures and 300 percent for non-publicly traded equity exposures. The agencies seek comment on the operational aspects of these floor calculations.*

Response 58: The floors in combination with other rules discourage the adoption of the IMA approach. Organizations using the IMA approach do not have the benefit of the lower 100% risk weight for non-significant equity positions.[55] Instead the 200%/300% floors would apply to these exposures and would limit the recognition of reduced risk due to portfolio diversification. The requirement to apply the floor at the aggregate level appears to pose no significant operational issues.

Question 59: *The agencies seek comment on the necessity and appropriateness of the separate treatment for equity exposures to investment funds and the three approaches in the proposed rule. The agencies also seek comment on the proposed definition of an investment fund.*

Response 59: We seek further clarification on the treatment of rated investment funds. Specifically, we wish to clarify that a permissible alternative is to risk weight an externally rated fund holistically based on the fund rating. Please see our comments on the definition and treatment of investment funds in Section IV. E.

Also, we believe investment funds that represent assets related to insurance activities should be excluded from risk weighting, as insurance capital requirements address this risk. Please refer to our response to question 23.

G. Operational Risk (Q. 60)

Question 60: The agencies are interested in commenters' views on other business lines or event types in which highly predictable, routine losses have been observed.

Response 60: We believe that the principle of offsetting EOL is sound, where evidence can be provided of "highly predictable and reasonably stable operational losses". Moreover, this principle should be applicable in any circumstances where such evidence can be provided. Securities processing and credit card fraud are two examples, but there are others including other types of fraud and common execution errors. The ability to offset will further encourage comprehensive loss collection and improved estimation of future losses. Please also see to our Operational Risk comments in Section V.

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[55] Section 53 (b) of the rule text (the rule for the RWA calculation under IMA) refers back to Section 52 (b)(1) through (3)(ii). Section 52 (b)(3)(iv) is omitted, implying that the 100% risk weight for "non-significant exposures" (under 10% of regulatory cap) does not apply to IMA.

H. Public disclosure and regulatory reporting (Q. 61-62)

Question 61: *The agencies seek commenters' views on all of the elements proposed to be captured through the public disclosure requirements. In particular, the agencies seek comment on the extent to which the proposed disclosures balance providing market participants with sufficient information to appropriately assess the capital strength of individual institutions, fostering comparability from bank to bank, and reducing burden on the banks that are reporting the information.*

Response 61: In our view, the purpose of public disclosure is to provide information that is meaningful to the firm, useful to investors, clear and consistent with other existing external reporting requirements. Moreover, disclosure requirements, in principle, should be consistent with how senior management assesses and manages the risks of the bank. Many of the required credit risk disclosures, such as the geographic distribution of consumer credit exposure or the residual contract maturity of the wholesale portfolio are already made in SEC or other public reports.

We strongly support the principle of increasing standards of public disclosure especially with regards to new and emerging activities or disciplines such as those related to operational risk. The standards of practice, data collection, risk measurement and analysis regarding this new risk category are only now emerging even among the industry leaders. It is reasonable to expect that operational risk disclosure standards will evolve in parallel with these overall developments. Notwithstanding this belief, we are strongly opposed to the public disclosures as outlined in the present proposal. The detailed information related to the component breakdown of operational risk capital will be confusing at best and most probably misleading in the public domain. This is particularly true given that there are no common definitions, methodologies or overall standards for the calculation of these data items and such data will not be comparable across individual banks. Putting such information into the public domain for a small number of banks serves no beneficial purpose at this time.

We are also strongly opposed to the proposed operational risk reporting requirements identified as confidential. Requesting such information of Basel II banks on a quarterly basis is contrary to the principles outlined in the Basel II Accord and in the consultative documents supporting the NPR. The effort is nearly tantamount to making the Quantitative Impact Studies for operational risk a quarterly exercise. While we certainly acknowledge the importance of supervisory oversight regarding risk measurement, no regulatory reporting effort has ever required banks to submit regularly the data actually supporting the computation of capital. Moreover, this detailed profile of loss information represents only a portion of the data used by banks to compute operational risk capital. So the effort required by banks to provide such data relative to the benefits served appears disproportionate. A program of periodic and specialized data requests (e.g. QIS initiatives) along with the annual reviews and examinations currently underway is a much preferred and entirely more efficacious approach to supervisory review of loss data and capital calibration.

While we appreciate the flexibility granted as to how and where credit risk disclosures should be made (e.g., on a website and not necessarily in a quarterly report), we do, however, have some concerns that the disclosures do not reduce the burden on banks, foster comparability, or allow users to assess capital strength. These concerns are described below.

Burden

The production of the credit risk disclosures represents a significant time burden due to the high degree of disaggregation. Moreover, these disclosures are expected simultaneously with the existing substantial volume of reports (regulatory as well as internal risk management) due at quarter-end. We ask that the agencies consider some degree of flexibility in the required release timing, particularly for data that is ancillary to the capital calculation.

There are several areas where the U.S. agencies, through the exercise of national discretions, increased the reporting burden on U.S. banks. For example, the Accord requires only semi-annual quantitative disclosures versus a quarterly cycle in the NPR.

We seek clarification that below the holding company level, the only public disclosures required are the capital calculations themselves and proposed reporting schedules A and B that support these calculations. Note that if we were to produce Pillar 3 disclosures for the significant bank and Edge Act corporations, our burden would increase six-fold.

We agree that it would not be appropriate during the parallel run period to release disclosures for public consumption (but they will be produced and shared with the agencies). Only after the qualification period has been completed and the bank has moved to the Basel II transition period, disclosures will be generated and placed in the public domain. This will allow for testing and guidance should it be needed on some of the necessary calculations. If this is not the correct interpretation, guidance would be appreciated.

We strongly believe that confidential and proprietary information should not be subject to public disclosure. We are concerned that the disclosures relating to internal ratings approaches in Table 11.5.b may include proprietary information.

We support the notion that disclosures not included in the footnotes to the audited financial statements would not be subject to external audit. However, we are concerned with the requirement that "the chief financial officer to certify that the disclosures required by the proposed rule are appropriate ..." In this case, certification is not sufficiently defined. We would approach the acceptance standard differently for Basel II disclosures versus what is typically done for financial reporting, given that many Basel disclosures are internal estimates of future conditions rather than financial in nature.

Comparability

Diversity among banks limits how feasible it is to make bank to bank comparisons with rigid, uniform, inflexible disclosures. For example, a bank in the servicing business

rather than the lending business may find that disclosures about operational risk are more relevant that those about credit risk. What is pertinent will differ by institution. As such, disclosures should be consistent with how senior management assesses and manages the risks of the bank. Requirements for more disaggregated data will do little to foster comparability.

As currently proposed, there will be a number of instances of the lack of comparability between the disclosures of U.S. banks and their non-U.S. competitors. This results largely from the fact that U.S. Pillar 1 calculations differ from the Accord and may result in inconsistent information across jurisdictions being provided to users. For example, LGD calculations differ and in earlier comments other examples are cited. In addition, the disclosure frequency in the U.S. varies from that in the Accord, increasing the difficulty of cross-border comparisons.

The quantitative disclosures require clear definitions and instructions for certain data elements. Specific terms, such as exposure-weighted average EAD (Table 11.5.c, see below), lack clarity. The definitions included in Section 2 of the NPR area not fully sufficient to ensure that the industry has a common language.

Capital Strength

The majority of the disclosures are not directly relevant to the assessment of capital strength. Some that are directly related to capital adequacy, such as Table 11.3, are already required disclosures for banks. We are, however, skeptical that the public will have the ability or even the desire to interpret complex data that is ancillary to the capital calculation. In place of much of the disaggregated data, we recommend that a summary discussion of the drivers of RWA be disclosed in conjunction with Table 11.3.

Comments on the Disclosure Tables:

11.4.b- We seek clarification that the collateral and haircut disclosures do not relate to retail exposures, since the nature of the underlying collateral is implied by the nature of the exposure and no haircuts apply.

11.5.b - We are concerned that the level of specificity in the "internal ratings process," including a description of specific variables used in the modeling process, could force us to disclose proprietary information such as specific quantitative techniques and variable design. We recommend a more general description of the types of variables considered.

11.5.c – The NPR diverges from the Accord (Part 4, Table 6.d) by requiring exposure weighted average capital requirements instead of the risk weight percentage. We request clarification of the correct exposure weighted formulas.

11.5.d – The term "actual losses" needs to be defined. The comparison of current default rates to estimates may not be meaningful unless the basis for the estimates is clearly set forth. For example, a comparison of current default rates to estimates based on a through-the-cycle approach would be misleading.

11.5.e - We are concerned that the requirement for a comparison of risk parameter estimates against actual outcomes is overly burdensome to produce and is not meaningful to the user. For example, in the case of wholesale it is not meaningful to produce quarterly actual outcomes for LGD when in fact it may take three or more years to resolve a default. We believe that an analysis of the actual long term average over the comparison period would perhaps be a more relevant disclosure.

We request clarification from the agencies as to how the comparison is meant to be done (e.g., variance analysis, portfolio composition, etc.).

We believe that disclosing a comparison of retail risk parameter estimates against actual outcomes is onerous and misleading, and would compromise proprietary information. The NPR requires an annual revalidation of segmentation structures, which addresses comparisons between estimates and outcomes as part of an evaluation as to whether models need redevelopment. A quarterly disclosure of differences between estimates and actual losses would require a complex assessment of model efficacy and overly simplify it into a basic numeric comparison. Users may incorrectly infer that models are performing poorly when in fact they are not, and in any case this evaluation should occur within the discipline of a revalidation effort, not a public report.

11.7.b – We oppose the NPR requirement to publicly disclose the RWA amount associated with exposures covered by guarantees and credit derivatives as it is both uninformative and burdensome. It is unclear how this disclosure will be meaningful for market participants to assess capital strength. We believe that disclosing the exposure amounts covered by credit risk mitigants as prescribed in the Accord should suffice.

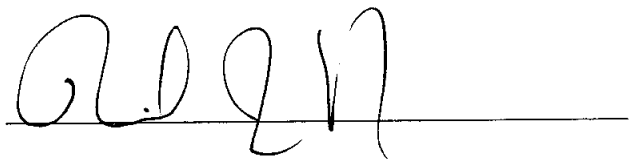
Question 62: *Comments on regulatory reporting issues may be submitted in response to this NPR as well as through the regulatory reporting request for comment noted above.*

Response 62: Please refer to Appendix B for our comments on the proposed regulatory reporting schedules.

Concluding Remarks

We appreciate the opportunity to comment on this NPR and support the effort to provide a more risk sensitive capital framework. If you have any questions, please contact Adam M. Gilbert, Managing Director, Risk Management, at (212) 270-8928.

Sincerely,



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Appendix A: Downturn LGDs and the NPR

Both the Accord and the NPR require the estimation and use of Downturn LGDs (DLGDs), rather than pure default weighted LGDs or Expected LGDs (ELGDs) in the Basel RWA formula. The rationale is based on the concern that during downturn economic periods when systemic effects cause higher default rates, LGDs may be higher than ELGDs. In such instances both internal economic and regulatory models should take DLGDs into account when determining capital requirements. An analysis of issues associated with incorporating DLGDs is set forth into the following sections of this appendix, concluding with a recommended approach:

1. Evidence linking LGDs and downturn periods
2. Analytical requirements for assessing DLGDs
3. DLGD application issues
4. Granularity and subportfolio effects
5. Use of advanced internal models
6. Conservatism in estimation of LGDs
7. Recommendation

1. Evidence linking LGDs and downturn periods

As acknowledged by the Basel Committee the evidence associated with downturn LGDs is unclear and "shows a range of results".[56] The primary assertion that LGDs are influenced by the level of defaults is based on examining public bond data, using the trading prices of these securities one month after default. It should be noted that some studies consider the initial trading price as an unreliable measure of LGD.[57] For example, institutional pressures often require CDO managers to trade out of defaulted securities regardless of their recovery potential. Conversations with workout specialists at banks also confirm this phenomenon.[58] In addition, in correlating LGDs to default rates some studies[59] rely on weighted average default rates in the high yield bond market as opposed to wider measures of systematic risk. Aside from the intrinsic measurement issues that have led to the conflicting views as to the nature and strength of this relationship, the fundamental issue is whether this can be observed in bank loan portfolios.

Bank loan recovery processes operate very differently, with LGDs measured by discounting cash flows over the recovery period. In most cases resolution periods extend over several years, such that some recoveries may take place during expansionary parts of the credit cycle. Even when discounting is applied to these cash flows, evidence of the

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[56] Guidance on Paragraph 468 of the Framework Document, July 2005, BIS, p. 1

[57] Bos, Roger, "Initial Trading Price: Poor Recovery Indicator for Defaulted Debt", January 14, 2003, Standard and Poor's.

[58] Anecdotally, a private communication revealed that one institution had sold a defaulted loan shortly after default at 60% while another held on to the same loan for 18 months and recovered 120%.

[59] Altman, Edward I., Resti, Andrea and Sironi, Andrea, "The Link Between Default and Recovery Rates: Effects on the Procyclicality of Regulatory Capital Ratios". BIS Working Paper No. 113 Available at SSRN: http://ssrn.com/abstract=846312

relationship between LGDs and default rates is quite mixed. In one study conducted over a 15-year period it was found that there was a moderate relationship between default rates and large corporate LGDs for unsecured loans but virtually no correlation for secured loans.[60] The ability to conduct further analysis of the degree of diversification of downturn LGD effects across segments of the portfolio such as industry and geographic regions is constrained due to limited data availability. However, it is typical that during significant downturns such as was experienced during 2001-2002 only certain industries such as technology sector exhibited high levels of default and high LGDs whereas other sectors did not seem similarly affected.

2. Analytical requirements for DLGDs

As set out in the NPR, DLGDs should be calculated using incident-weighted averages rather than period-weighted averages. If downturn conditions have the effect of increasing LGDs, the presence of more defaults with higher LGDs will tend to increase DLGDs determined using an incident-weighted calculation.[61]

Assuming that there is sufficient data, one could evaluate the degree to which DLDGs may be present. In doing so, the bank would be faced with a number of difficult choices as to how to conduct the analysis. The bank must first choose an indicator of "downturn conditions." This could be the level of defaults that it experiences in its own portfolio or some external indicator. In either case, the bank will need to decide whether to use a global level of default conditions or a more local one, such as "strictly within the United States." The more global the indicator, due to inherent diversification effects, the less likely it is that all segments of the portfolio will experience downturn conditions at the same time and this may dilute the assessed impact on LGDs. The less global the indicator, aside from more limited data, the more difficult it may be to piece together the separate analyses and conclude that their effects may be coincident or at least within the one year horizon underlying the Basel II RWA formula.

This issue becomes more entangled when it is noted that certain industries more than others seem to have high default rates during downturn conditions. Thus while both the technology sector and the non-technology sectors experienced downturn conditions during 2001-2003, the technology sector's default rates were at least double that of the non-technology sector during that period.[62] During prior periods the default rates of these groups were quite similar. An empirical analysis of associated LGDs during this time period would be more heavily weighted towards the higher incident LGDs associated with the technology sector. In a similar manner, the examination of the 1989-1991 recession would be more heavily weighted towards the commercial real estate and hotel

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[60] Araten, M., M. Jacobs, Jr., and P.Varshney (2004), "Measuring LGD on Commercial Loans: An 18-Year Internal Study", *RMA Journal*, May. Based on using the Moody's all-corporate default rates, the adjusted R-square for unsecured loans was 20% and for secured loans it was 2%.

[61] The incident-weighted LGDs was 5% higher than the period-weighted LGD for JPM over a 19 year period as could be observed in Araten, Jacobs and Varshney (op cit).

[62] JPMorgan Chase analysis of Moody's Corporate Default Rates, using Moody's DRS' Credit Risk Calculator.

sectors which experienced outsized default rates relative to other sectors, while the disparity in default rates during the 2001-2003 period was not significant.

It should also be noted that a bank needs to choose whether it will measure default rates as the most direct proxy for downturn conditions across all rating categories or will focus solely on speculative versus investment grade issues. This choice is particularly important for a bank that may have very large concentrations in exposure to financial institutions and governments which are expected to have low default rates.

3. DLGD application issues

Evidence that LGDs may be higher during periods of high default periods may manifest itself in a number of ways.

If sufficient data is available correlations between annual LGDs and annual system–wide default rates may be calculated along with adjusted R^2's. Given the RWA formula, it is not clear how to translate a calculated R^2, say 25%, into a DLGD.

Where insufficient data exists to calculate a statistically significant correlation, it may still be noted that in a particular stress period, such as during the 1989-1991 recession, LGDs appear to be higher than the average of all other years in the data set. For example, if it were found that LGDs were higher by say, 30%, due to the preponderance of real estate defaults it is not clear that scaling up all LGDs by 30% is an appropriate approach. A bank's current portfolio composition could be radically different from that which existed in the stress period and conclusions regarding the presence and applicability of DLGD effects should be carefully examined. In addition, given the fact that an incident-weighted LGD is used to calculate the average LGD, it is not clear whether a scalar based on a stress period versus the average of other non-stress periods should be applied to the incident-weighted or to the period-weighted LGD.

The scaling formula[63] suggested by the NPR in fact derives DLGDs relative to average LGDs in a non-linear, disproportionate manner. For example, exposures with average LGDs of 25% would require DLGDs and capital to be 24% higher. Low LGD exposures in the range of 5% would have their DLGDs and associated capital increased by over 250%.

Thus, different approaches to applying the effect of a downturn to LGDs could result in widely different impacts on regulatory capital depending on the underlying empirical data, the analytical process and the form of the application.

4. Granularity and subportfolio effects

Requiring banks to provide downturn LGD estimates for subdivisions of entire rating categories, such as industries or regions, creates both estimation and implementation problems and further distances regulatory capital from economic capital practices.

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[63] LGD = 0.08 + 0.92 x ELGD

Assuming that systematic downturn conditions affect LGDs, as noted above, it would be unusual for these to take place at all subdivision levels over the same time period.

Selecting the worse of the LGDs for each of these subdivisions in an ASRF capital formula violates basic portfolio theory and the recognition of diversification effects. Should the regulations specify a common time frame such as a specific recession year that resulted in the highest overall LGD percentage for the bank as a whole, then one might very well discover some subdivision LGDs that were lower for that year than their average default weighted LGDs.

As noted above, the incorporation of a downturn LGD into the Basel RWA formula as a linear adjustment to RWA is a less than ideal approach to incorporating systematic correlation of LGD and PD effects. The degree to which this correlation affects capital requirements is very much a function of portfolio composition and the degree to which downturn effects if any, occur over the same time horizon for subdivisions of the portfolio. Banks may have sufficient historical data to determine the degree to which downturn LGDs are observable for different types of facilities. For example, as noted earlier, empirical data may show that periods of recession do have impact on unsecured LGDs but not on secured LGDs. These effects could be quantified by measuring the correlation for these facilities. A bank may not have sufficient data for all of its segments to evaluate DLGDs. However, this should not result in an "all-or-nothing" application wherein the absence of correlation analysis for each segment results in the use of the suggested supervisory formula across the entire portfolio.

5. Use of advanced internal models

Banks that have sufficient information to be able to determine the degree of DLGD correlation for different segments of their portfolios may also have internal economic capital models that incorporate such effects. These models may specifically tie in a set of systematic conditions to points on the LGD distribution of various assets as part of the economic capital simulations. To the extent models can be run with and without the LGD systematic effect relationship one could discern the relative increase in capital associated with DLGDs under Basel II's RWA.

The use of these models should enable a proper assessment of diversification issues associated with different segments of the portfolio which may or may not exhibit downturn effects in the same period. The results obtained from running the models can inform the proper scalar mapping effect that might be applicable for a specific institution's portfolio.

6. Conservatism in estimation of LGDs

There are a significant set of issues associated with estimating LGDs without even considering downturn conditions. Unlike bonds which have exposures, structures, and collateral that are dictated by the terms of their indentures and generally do not change over their lives, the terms of bank loans can and do change significantly over their lives.

In fact, bank loans are designed to be flexible and to afford banks the ability to improve their recovery prospects as credits deteriorate. Thus, a bank's loan exposure and associated collateral is likely to be quite different at the time of default compared to its condition at the time of origination. LGDs are by definition to be determined based on their condition at the time of default but are then to be applied in an RWA formula to loans that are in the performing portfolio. There are a number of ways in which the application of LGD estimates will by nature be conservative and will overstate capital requirements.

As credits decline in quality borrowers may seek relaxation of covenants and related terms. In return, banks will press borrowers and negotiate for a decrease in exposure. This may be accomplished by encouraging the borrower to sell assets or divisions of the company to pay down exposure. The assets that have the best chance to be sold are the better quality ones, leaving the borrower and the bank with poorer quality assets. In the event that the borrower eventually defaults, the LGD will be relatively high since it will be based both on a lower exposure at default as well as assets which have lower recovery prospects. The resulting LGD will be incorporated into the overall estimate that will be applied to newly originated loans and to currently performing loans. Best practice should have the bank estimate a lower LGD at origin anticipating that exposure is likely to be reduced and increase the LGD estimate following the exposure reduction. However, most banks will find this practice difficult to implement and instead will simply use the higher LGD based on the reduced exposure at default in an attempt to be conservative.

In the same vein, banks extending loans that are unsecured at origination may also benefit from imbedded covenants or borrowers desires for flexibility. As credit quality deteriorates banks will negotiate for collateral or structural priority. If the negotiations are successful, while the loan may eventually default, at the time of default the LGD recorded will be reduced reflecting the improved collateral position. In contrast there may be unsecured loans for which no improvement in collateral or structure is obtained and which will reflect a higher LGD. The application of the higher unsecured LGD to newly originated unsecured loans will fail to recognize the likelihood that some of these may become secured and at the time of default have higher recoveries. While this is also an opportunity for banks to assess an LGD for an unsecured loan that reflects the likelihood that the loan's profile at the time of default will more closely resemble that of a secured loan, banks may follow the more conservative approach.

In many instances, recoveries take place over an extended resolution. Normally, banks will seek to include as many resolved loans as possible in their LGD estimates to improve their statistical significance. A bank may have recorded say, 90-95%, of the cash flows that it ultimately will receive over a 2-3 year period and while it has not given up a legal claim to additional recoveries will seek to consider the loan "resolved" without including an estimated recovery stub. This will tend to overstate the LGDs.

As wholesale bank loan recoveries take place on average over a 3 year period, it is important to apply an appropriate discount rate to the cash flows. The choice of the discount rate to be applied to bank loan recoveries may also be viewed as a function of

the correlation between LGDs and systematic default rates. To the extent that correlations are demonstrated not to exist, one can argue that the discount rate can even approximate the risk free rate[64] plus some factor accounting for liquidity. Bank practice is to use a substantially more conservative rate for discounting purposes.

7. Recommendation

We see that the evidence for associating high LGDs with systematic default rates is questionable for bank credit exposures. The analytical choices for establishing these relationships, the application of DLGDs, and the treatment of sub portfolios can be quite varied with concomitant impact on regulatory capital. While some banks may be able to use their internal economic models as a way to estimate the DLGD effect on RWA and incorporate the spirit of the regulatory requirement, this is just one of the approaches that can be followed.

Rather than follow a prescriptive set of mapping rules over a principles-based approach, supervisors should examine the relative degree of conservatism practiced by banks in measuring LGD as a counterpoint to incorporating a specific downturn LGD. Considerations of conservatism include analysis of exposure reduction prior to default, analysis of collateral present at the time of default versus at origination and choice of discount rates, all of which tend to overstate the LGD percentages when applied to the non-defaulted segments of the portfolio.

To the extent that banks can demonstrate sufficient conservatism in their estimation processes, the need to apply markups via a supervisory formula to obtain a downturn LGD may be obviated.

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[64] Gordy, Michael, "Portfolio Credit Risk Modeling: A Regulatory Perspective on the State of the Art". Presented at Recent Advances in Credit Risk Research, NYU Stern, New York, May 2004.

Appendix B: Comments on Basel II Reporting Requirements

Below are our comments on the proposed regulatory reporting requirements for banks that qualify for and adopt the Advanced Capital Adequacy Framework to calculate their risk-based capital requirements or are in the parallel run stage of qualifying to adopt this framework, as published in the Federal Register on September 25, 2006.[65] Comments on the specific schedules and instructions are based on the version of the schedules and instructions as published on the ffiec.gov website.[66]

Summary

We have the following concerns with respect to the proposed reporting requirements:

- We oppose the alternative proposal to require a "lookback" portfolio calculation. While we agree conceptually that there are benefits to collecting and analyzing additional data on the same exposures over multiple time periods (the "lookback" portfolio), we believe further dialogue with the industry is needed to determine the appropriate data and an efficient method for collection. We believe the most efficacious way to collect such information is through periodic specialized data requests, reviews and examinations. We oppose a quarterly requirement to provide information on the full set of common exposures across multiple periods. Quarterly calculation of a lookback portfolio would place a significant additional burden on our reporting resources and may even require complex reruns of our capital calculations. In addition, we believe that it is not feasible to add such a requirement for the 2008 parallel run period given the lead time needed for process and system development.

- We oppose the alternative proposal to require each firm to supply more detailed information on every obligor rating grade and retail segment. This would result in very large and detailed retail schedules given the large number of segments, running into the hundreds or thousands, typically employed. We believe this alternative may have limited value since retail segmentation data could not be put on a comparable basis across peer banks, given each bank's ability to segment according to different risk drivers.

- We believe that banks will not have the necessary lead time to implement any further reporting changes to Schedules A-V in the final rule. Since the final requirements are not expected before late 2007, 2008 reporting will largely be based on our current interpretation of the current forms and instructions for Schedules A through V.

- With respect to Schedules C through V, we consider certain data items such as our internal obligor rating grades and segmentation to be proprietary. While this

[65] *Federal Register*, Vol. 71, No. 185, September 25, 2006: p. 55981

[66] *Reporting Under the Advanced Internal Ratings-Based and Advanced Measurement Approaches Schedules A through V*. FFIEC draft, August 20, 2006.

data can be made available to the supervisors, we strongly support section III.B of the regulatory reporting requirements which states that this information will not be publicly disclosed.

- We oppose additional reporting requirements unrelated to data compiled in the course of computing Pillar 1 capital. In particular, certain retail data such as LTV and bureau scores which may not align with a banking organization's chosen retail segmentation schemes should not be required to be produced quarterly.

With respect to operational risk (Schedule V), we oppose the detailed information requirements and additional disclosures for the reasons stated in the Executive Summary of this comment letter.

We believe that many of our concerns can be addressed by eliminating requirements that are not contained in the Accord, which will provide a better degree of competitive parity across jurisdictions and also reduce the reporting burden on institutions subject to the U.S. version of the Accord.

Responses to Specific Questions

(1) *The agencies seek comment from the industry concerning the feasibility of collecting certain additional information beyond that described in the NPR.*

Reporting banks would be required to submit additional data items that summarize current and previous risk parameters for exposures that were in wholesale and retail credit portfolios as of the previous reporting period (for example, prior quarter, prior year) -- the "lookback" portfolio. A lookback-portfolio approach would require additional data collection and processing. For example, banks would need to retain data on the internal risk rating category to which each exposure was previously assigned, and the previous EAD of each exposure. The agencies believe that this data maintenance requirement is consistent with supervisory expectations described in the NPR and proposed AIRB guidance.

- *What aggregate summary information might banks submit that best describes or characterizes period-to-period migration across internal rating grades or retail segments?*

- *If such information were required, are there particular formats or other considerations that would reduce the reporting burden for banks?*

Response: While we recognize the desire on the part of the agencies "*to better identify reasons for observed changes in regulatory credit risk capital requirements and allow for peer comparisons of changes from period to period*"[67], we oppose a mandatory quarterly

[67] Federal Register, Vol. 71 no. 195. September 25. 2006: p. 55986.

requirement to provide data on common exposures across periods. Apart from the observation that this undertaking would require substantial lead time from final proposal to actual implementation, it is not apparent that a quarterly reporting requirement is the most efficient or effective way to meet the agencies' objectives.

Alternatively, we suggest that the agencies use banks' internal analyses of migration to gain insight into the causes of changes in credit risk regulatory capital. This approach would also minimize the burden on banks.

Please note that quarterly reporting for the lookback portfolio as proposed is likely to require rerunning capital calculations and further investment to develop and maintain processes to match all current exposures to prior year or quarter.

With regard to period-to-period migration across retail segments, please see our earlier comments on retail seasoning.

(2) *The agencies are considering another alternative reporting treatment with respect to the wholesale and retail portions of the above proposal (Schedules C-R). This alternative treatment would complement the lookback-portfolio approach just described but could be implemented whether or not the lookback-portfolio approach was implemented. Under this approach, banks would submit data according to each of their internal obligor rating grades or segments, rather than in the fixed bands defined in the current regulatory reporting proposal. In this case, each reporting bank could submit a different number of rows corresponding to the number of internal risk rating/segmentation categories employed by that bank for the given portfolio.*

- *Would reporting burden be lessened if banks submitted data using internally-defined obligor grades or segments, rather than aggregating the grades or segments in supervisory reporting bands?*

Response: For wholesale portfolios, we see little, if any, difference in compiling data using fixed bands as predefined in the current proposal versus using internal obligor rating grades or segments. While we have not fully reconciled the proposed fixed bands to our internal obligor rating grades or segments, the concept is fundamentally the same.

For retail portfolios, we believe it is more appropriate to apply the same standard bands across institutions. We find this approach more practical, reflective of appropriate risk levels, and easily interpretable across institutions. Requiring banks to submit data for all retail segments, or aggregations of segments selected by each institution, would eliminate this comparability. For segmentation schemes, this would also be extremely unwieldy, since there are typically far more segments than the stated PD bands, and segmentation schemes can vary by exposure subcategory or subdivision. We have difficulty seeing how segment-level details derived from multiple and varied segmentation schemes could be reported efficiently. This proposal would also require some definition of the

segmentation schemes in the reports themselves (i.e. we assume "segment A" undefined would not be acceptable), which would raise competitive disclosure concerns.

(3) *The agencies request comment on the appropriateness of making the data items on Schedules A and B and data items 1 through 7 of the operational risk reporting schedule (Schedule V) available to the public for each reporting entity for data collected during periods subsequent to its parallel run reporting periods as currently proposed. Comments are requested on the extent to which banks are already providing these data to the public or are planning to make such data public as well as the timing of these disclosures. In addition, comments are requested on the perceived risks associated with public reporting of these data items.*

Response: We find Schedule A differs little from current reporting of the elements of regulatory capital. Schedule B breaks down risk-weighted assets in a very different manner for the current Schedule HC-R, and some of the information is neither presently disclosed nor included in the Accord disclosures. An example is the breakdown of undrawn lines by exposure category. We urge the agencies to consider carefully the implications of any new disclosures. Please also see our comments on disclosure under Question 61 above. Further, we note that Schedule B reports Expected Credit Loss using ELGD, not LGD, which is inconsistent with the Accord. Please also see our comments on LGD above.

Schedule V (operational risk)
We are strongly opposed to the public disclosures as outlined in the present proposal. The detailed information related to the component breakdown of operational risk capital will be confusing at best, and most probably misleading in the public domain. This is particularly true given that there are no common definitions, methodologies or overall standards for the calculation of these data items and such data will not be comparable across individual banks. Putting such information into the public domain for a small number of banks serves no beneficial purpose at this time.

(4) *What changes in the proposed regulatory reporting requirements for the Advanced Capital Adequacy Framework, including additional data or definitions, would better assist the agencies in reaching their stated goals? In this regard, the agencies also seek input on possible alternative ways to capture the requested information and the appropriateness of the requested data given the stated purposes of the information collections and the associated reporting burden.*

Response: While the proposal does not discuss the method of submission, we understand that the method of filing is expected to be the same as the current process today for the FR Y-9C and Call Reports. We would require final specifications several months in advance of the date the final reporting requirements are published to allow for sufficient lead time to design, build, and test such uploads for the "go live" date.

Specific Comments on Reporting Schedules

Additionally, we have the following comments related to the specific schedules and instructions.

PD Ranges
All of the wholesale exposure schedules require exposure to be broken down by specific PD ranges. However, the PD ranges for OTC derivatives and repo-style transactions in Schedules I through K are different from the other wholesale exposure schedules. We would propose that there be a consistent set of PD ranges for all wholesale disclosures.

Instruction Conflicts
Schedule I is for derivatives and repos subject to **cross-product netting**. The related instructions for Schedule I say to "report all eligible margin loans, repo-style transactions and OTC derivatives positions that are subject to a **qualified master netting agreement** as defined in the NPR. Exposures that are not covered by netting agreements or whose netting agreements do not meet the standard called for in the NPR to qualify for netting under the capital rules will be reported separately as gross exposures in the following two schedules." This is problematic in that transactions may be covered under a qualified master netting agreement but not a cross-product (i.e., one that allows netting of OTC and repos) netting agreement. Schedule J is for eligible repo-style transactions that are **not** subject to a master netting agreement. By the NPR definition, a repo-style transaction **must** be subject to a netting agreement.

We will interpret the instructions such that Schedule I is for transactions under cross-product netting and Schedules J and K are for trades not under cross-product netting but may be subject to single-product netting.

Unsettled Transactions
There is no requirement to disclose RWA associated with unsettled transactions. Furthermore, the capital calculations for unsettled transactions do not require the use of PD and LGD, so there is no natural place on Schedules B through H to report this RWA. We would look to the agencies for clarification that this is indeed not a requirement.

Retail Schedules
In general, we believe the schedules should be focused on data needed for Pillar I calculations, and should not require data such as LTV or bureau scores intended to address other issues. Such data is not necessarily fully aligned with an institution's retail segmentation scheme.

We believe the information in the proposed final column "P" on the Mortgage Schedules L, M and N, EAD of accounts with updated LTV, is of very limited value and would be onerous to produce. This would require comparing the data files for any given cycle against submissions from the prior cycle, which is not necessitated by any other reporting requirement.

Many firms employ original rather than updated LTV in mortgage and Home Equity Line of Credit (HELOC) segmentations, due primarily to the difficulty of creating a full five-

year time history of migrating LTVs. We do not believe that employing updated LTVs would add significant PD estimation accuracy relative to cost. Consistent with our peers, we update the value of the underlying collateral when accounts reach a certain delinquency state, which varies by exposure type.

We recommend employing one of the following alternatives:

1. Eliminate the column from the schedules and address the underlying issue in Pillar II;
2. Specifically explain the objective of the requirement and solicit comment on alternative means to address it;
3. Explicitly state a materiality standard for the reporting, e.g. if the changed LTVs relate to less than 10% of the outstanding balance of that portfolio, the data would not be required. This would permit agencies to identify institutions that realized a significant change in EAD resulting from a large-scale re-evaluation of underlying collateral without requiring this data in situations where it will add no value.

The first footnote to Schedules L, M and N states that:

- LTV cell values are cumulative EAD totals.
- LTV values are calculated by combining any junior lien amounts with the exposure amounts applicable to this report.

We assume by "cumulative" the agencies do not mean that the column totals themselves cumulate, i.e. the amounts in column K should not also include amounts in column J, since this would conflict with the column definitions as listed. We seek confirmation of that understanding.

"Any junior liens" could be interpreted as stated, i.e. that <u>any</u> junior liens, regardless of who holds the exposure, must be included in the LTV calculation. This is highly impractical, because junior lien information is dynamic and attempts to monitor it are particularly unreliable. Even if this were limited to junior liens held at the reporting institution, it would be very difficult, requiring an exposure mapping functionality that could not be done easily due to multiple mortgages held on various properties by a single mortgagor at a single institution. In addition, the reports would then twice reflect the effect of the exposure.

We support including senior liens in the calculation of what is in effect "Cumulative Loan to Value", or CLTV, for junior lien exposures, since this is appropriate and widely applied in the industry for junior liens. We recommend that this be stated explicitly in a replacement first note, and limited to Schedules M and N, where junior liens will appear.

Securitization

There is no requirement to disclose the amounts that are deducted from capital under the RBA or IAA. These exposures would be rated more than one category below investment grade if long-term and below the third-highest investment grade if short-term. Inclusion of the exposures in item 5 of Schedule S would be inconsistent with how deduction

amounts are treated in Schedule T. In addition, these amounts would not fit in line 1 or 2 of Schedule T. We would look to the agencies for clarification that this is indeed not a requirement. We believe the line 6B requirement (to report total RWA for securitization exposures if not capped by the maximum risk based capital requirement related to early amortization) is burdensome because this would require re-running the calculation process without the cap for each exposure. This information is better captured through examination rather than quarterly reporting.

Reporting of Balance Sheet Amounts on Schedule B
In the current FR Y-9C and Call Reports, the balance sheet asset totals in column A of Schedules HC-R and RC-R must agree to the balance sheet (Schedules HC and RC). The proposed Schedule B does not indicate that the balance sheet amounts must agree to the balance sheet amounts provided on Schedules HC and RC. We recommend that the supervisors consider revising Schedule B to allow for agreement of the balance sheet amounts to Schedules HC and RC to ensure that all balance sheet assets have been considered in the risk-weighted asset calculation.

Estimated Reporting Burden

Additionally, we provide the following comments related to the supervisors' estimate of reporting burden.

The supervisors estimate that a total of 52 OCC-regulated national banks and 15 Federal Reserve-regulated bank holding companies would incur a burden of 280 hours per response. While we appreciate the difficulties in determining the estimated burden, we believe that the supervisors' estimate is significantly underestimated for large banking organizations based on the burden we currently incur in satisfying the regulatory reporting requirements for the bank holding company and the lead bank only. While additional legal entities within the scope of Basel II may be smaller in size, the burden for current filing is not significantly less. Furthermore, each of the Firm's lines of business will incur significant burden throughout each quarter in compiling and enriching their data to meet the proposed regulatory reporting requirements, particularly in light of the amount of detail currently proposed by the supervisors.

Appendix C: Comments on the Basel 1A NPR

Below are our comments on the proposed modifications to the existing risk-based capital framework (Basel 1A).[68] These modifications are intended for those institutions not subject to the Advanced Capital Adequacy Framework, as an alternative to the existing capital framework (Basel I). As a core Basel II banking organization, we will be required to implement the U.S. version of the Advanced Capital Adequacy Framework and will not have the option to adopt Basel 1A.

In response to this Notice of Proposed Rulemaking (NPR), we are not commenting in detail on the Basel 1A capital rules, but are limiting our remarks primarily to the last four questions posed in the text that relate to Basel II.

To summarize our responses below, we strongly support the adoption of alternative approaches to the most advanced Basel II approaches in the U.S. including the Standardized approaches to credit and operational risk. We believe such approaches should be open to all banking organizations and their use should not merely be on a temporary basis. In our view, a key difference between Basel 1A and the Standardized approach is the treatment of operational risk. If Basel 1A does not explicitly require an operational risk charge, then the 1A risk weights should reflect operational risk considerations. We oppose additional U.S.-only incremental requirements for Standardized and other alternative Basel II approaches that would lead to competitive inequities due to international inconsistency or would impose requirements that would lessen the risk sensitivity of the approach.

Possible Alternatives for Basel II Banking Organizations

In the Basel II NPR, the agencies inserted an additional question requesting comment on whether "*Basel II banking organizations should be permitted to use other credit and operational risk approaches similar to those provided in the Accord.*"[69] In this Basel 1A NPR, the agencies seek comment on all aspects of the following questions and "*seek the perspectives of banking organizations of different sizes and complexity.*" Since this NPR poses significantly more detailed questions regarding the rules that would apply to Basel II banks, we are responding to them in order to ensure that the agencies have a fuller appreciation of our support for the adoption of alternative Basel II approaches.

Question 19: To what extent should the agencies consider allowing Basel II banking organizations (mandatory and opt-in banks as defined in the Basel II NPR) the option to calculate their risk based capital requirements using approaches other than the Advanced Internal Ratings Based (A–IRB) approach for credit risk and the Advanced Measurement Approach (AMA) for operational risk? What would be the appropriate length of time for such an option?

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[68] *Federal Register*, Vol. 71, No. 247, December 26, 2006: p. 77446.
[69] Federal Register, Vol. 71, No. 185, September 25, 2006: p.55841.

Response: As stated above, we fully support offering all U.S. banks the option to adopt any of the less advanced Basel II approaches for operational risk and credit risk contained in the Accord, including the Standardized approach. Banks would thus be permitted to choose an approach that takes into account benefits of improved risk sensitivity, competitive considerations, implementation cost and operational complexity. Any alternative that limits the options open to banks runs the risk of creating competitive inequities, since some banks will be required to adopt an approach that they would find sub-optimal. We do not believe that permission to adopt Standardized or other simpler Basel II approaches should be limited only to Basel II banks, as this will not provide the benefits of choice for other banks on an equal footing with Basel II banks.

We oppose the use of the Standardized or other approaches by Basel II banks on a temporary-only basis. This suggests that use of a less advanced approach is only a steppingstone to a more desirable A-IRB and AMA final state. We believe the intent of the Accord was to provide other approaches on a more permanent basis. In other jurisdictions, banks can choose to remain on less advanced approaches indefinitely or move to the more advanced approaches at a later date at the bank's discretion. Please refer to our earlier comments for further elaboration on this issue.

Question 20: If Basel II banking organizations are provided the option to use alternatives to the advanced approaches, would either this Basel IA proposal or the Standardized approach in Basel II be a suitable basis for a regulatory capital framework for credit risk for those organizations? What modifications would make either of these proposals more appropriate for use by large complex banking organizations? For example, what approaches should be considered for derivatives and other capital markets transactions, unsettled trades, equity exposures, and other significant risks and exposures typical of Basel II banking organizations?

Since the stated objective of Basel II is to provide a more risk sensitive risk-based capital framework, Basel II banks are almost certain, given their support for this goal, to prefer the Basel II approaches to Basel 1A.

An overly detailed comparison of Basel 1A and Standardized rules is not particularly meaningful given the very fundamental differences between them, including:

- Scope: The Standardized approach is part of an international accord whereas Basel 1A is by design a modification of the existing framework for domestic institutions;
- Operational Risk: There is not recognition of Operational Risk in the Basel 1A framework.
- Disclosure: There are no additional disclosure requirements in this NPR, whereas Pillar 3 is a fundamental building block of the Basel II approaches.

If Basel 1A were modified to remedy these fundamental differences and begin to address the more complex activities of large international banks, the result would be a set of rules closely resembling the Standardized approach. If Basel 1A were to include a separate operational risk capital requirement, for example, then questions would inevitably arise

regarding the justification for any detailed differences in credit risk weights between Basel 1A and Standardized rules. Not only would there be little rational for such differences, but this would once again raise the issue of creating consistency across jurisdictions and a level playing field for all competitors.

With respect to further modifications to the Standardized approach, we believe the Standardized rules contained in the Accord can be adopted without change and be suitable for use by Basel II banks. This approach is the result of several years of development by the Basel Committee, and any further modifications deemed necessary should be introduced only after consultation with the Committee, so that there is the highest degree of international consistency and the least degree of competitive inequity in the application of the rules at the national level. In our view, a rule to allow use of the Standardized approach without modification in the U.S. can be introduced without undue delay, given that these rules have already been introduced in other jurisdictions.

Question 21: The risk weights in this Basel IA proposal were designed with the assumption that there would be no accompanying capital charge for operational risk. Basel II, however, requires banking organizations to calculate capital requirements for exposure to both credit risk and operational risk. If the agencies were to proceed with a rulemaking for a U.S. version of a Standardized approach for credit risk, should operational risk be addressed using one of the three methods set forth in Basel II?

Yes, a U.S. version of the Standardized Approach should address operational risk using one of the three methods set forth in the Accord.

Question 22: What additional requirements should the agencies consider to encourage Basel II banking organizations to enhance their risk management practices or their financial disclosures, if they are provided the option to use alternatives to the advanced approaches of the Basel II NPR?

The computation of an adequate capital requirement and the employment of sound risk management practices are separate processes, even though the effectiveness of the latter impacts the capital number. This is true irrespective of the method of capital measurement. Adequacy of risk management practices should continue to be monitored as a regular part of the supervisory review process and any noted deficiencies addressed on a timely basis.

In general, we oppose additional requirements for financial disclosure or other additional requirements beyond those already specified in the Accord for any of the alternative advanced approaches that would apply only to banking organizations subject to the U.S. version of Basel II rules but not to other competitors. Please see our comments above on disclosure and the need for international consistency to maintain competitive equity.