



800 Nicollet Mall  
Mail Code: BC-MN-H23G  
Minneapolis, MN 55402

Andrew Cecere  
Chief Financial Officer  
Vice Chairman

612 303-0830  
612 303-0838 fax

March 26, 2007

Office of the Comptroller of the Currency  
250 E Street, S.W.  
Public Information Room  
Mailstop 1-5  
Washington, D.C. 20219  
Docket number 06-09

Ms. Jennifer J. Johnson  
Secretary  
Board of Governors of the  
Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, N.W.  
Washington, DC 20551  
Docket R-1261

Mr. Robert E. Feldman  
Executive Secretary  
Attention: Comments  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, N.W.  
Washington, DC 20429  
RIN 3064-AC73

Ladies and Gentlemen:

U.S. Bancorp welcomes the opportunity to respond to the Agencies' Notice of Proposed Rulemaking ("NPR") for the Advanced Capital Adequacy Framework. The process for developing a new risk sensitive framework has been an extended process with substantial enhancements and modifications over the past several years. We are very pleased to participate in this process.

Our detailed comments are set forth in the attachment to this letter, which is organized into separate sections related to the AIRB, disclosures and other matters. In addition to those detailed comments, as the NPR is finalized, we believe that careful consideration should continue to be given as to whether all three approaches outlined in the Basel II Accord for operational risk capital should be permitted. If all three approaches are allowed, or are allowed for a longer period of time, banks in the U.S. could perhaps follow a path more tailored to the complexity of their risk profile, while still assuring that the primary risk management goals of Basel II are met. In addition, the flexibility afforded by permitting all three approaches might allow practices in the industry to more fully and naturally evolve, and this evolution may be more optimal for all participants. We believe that these issues are very important, and worthy of careful consideration as the NPR is finalized.

Again, we appreciate the chance to submit our comments, and look forward to the next steps in this important process.

Sincerely,



---

Andrew Cecere  
Vice Chairman and Chief Financial Officer  
U.S. Bancorp

## Detailed Comments on Advanced Capital Adequacy Framework NPR

### I. Advanced Internal Ratings Based Approach

#### 1. LGD Mapping Formula

The NPR provides two methods for a bank to generate estimates of LGD for wholesale and retail exposures. One method employs a supervisory mapping function. This mapping function is a simple linear transformation of a Bank's estimate of ELGD into LGD. The second method requires banks to estimate LGD based solely upon internal data. The NPR states that a bank has a choice between the two methods, but only one method can be used for all assets in a particular Basel Category (the Basel Categories are Other Retail, Residential Mortgage, Qualifying Revolving Exposure, Corporate Non-HVCRE, and Corporate HVCRE). Thus, a bank that generates estimates of ELGD and LGD for a single portfolio in a category (e.g. Other Retail), must do so for all portfolios in that category.

While we appreciate the simplified nature of the supervisory mapping function and banking agencies' efforts to implement a consistent treatment across all assets in a particular Basel category, we highlight one drawback to the mapping function approach. This approach unduly penalizes assets with a U.S. Government guarantee. This is because using the mapping function on government guaranteed assets results in an LGD that exceeds what would be expected from the U.S. Government even during an economic downturn period.

Exposures with a Federal Government guarantee have lower loss severities in the event of default. It is because of these guarantees that banks lend to certain borrowers. Some examples include Federal guarantees on residential mortgages (e.g. FHA or VA), small business loans (e.g. SBA), and student loans. While a bank may incur some loss on assets with a U.S. Government guarantee, it is unrealistic to assume that the severity of loss will fluctuate with the economic cycle. Fluctuating losses with the economic cycle would imply that the Federal Government's repayment capacity also fluctuates with the economic cycle. We find this treatment inconsistent with the treatment of other Federal Government exposures in the NPR.

We recommend that the Agencies allow banks to use the same LGD and ELGD for assets secured by Federal Government guarantees when using the supervisory mapping formula. Without this adjustment, the current rules may have the effect of reducing banks' use of government guarantees to provide credit to wholesale or retail borrowers with elevated default characteristics.

#### 2. HVCRE Definition

The NPR provides the following definition for high volatility commercial real estate (HVCRE) exposures:

*High volatility commercial real estate (HVCRE) exposures mean a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property, unless the facility finances:*

- (1) One- to four-family residential properties; or
- (2) Commercial real estate projects in which
- i. The loan-to-value ratio is less than or equal to the applicable maximum supervisory loan-to-value ratio in the [AGENCY]'s real estate lending standards at 12 CFR part 34, Subpart D (OCC); 12 CFR part 208, Appendix C (Board); 12 CFR part 365, Subpart D (FDIC); and 12 CFR 560.100-560.101 (OTS);
  - ii. The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised "as completed" value; and
  - iii. The borrower contributed the amount of capital required by paragraph (2)(ii) of this definition before the [bank] advances funds under the credit facility, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project.

We appreciate the thorough definition of HVCRE; however, we believe that the definition is too broad. We suggest that you consider the following points.

- As written, this definition will potentially result in all income producing real estate (IPRE) to be treated as HVCRE. This is because of the first sentence, which states that a credit facility that finances or has financed the acquisition, development and construction (ADC) of real property is to be categorized as HVCRE. This phrase implies that loans financing stabilized commercial real estate projects would be treated as HVCRE because they may have financed the construction and/or lease-up phase of the project.

We recommend the Agencies modify the definition of HVCRE to exclude stabilized commercial real estate facilities. We believe that the definition of HVCRE should be based upon the current risk characteristics of the project, rather than the prior risk characteristics of the project such as if the bank has funded the project through the ADC phase of the project.

- The wording in sections (2)(ii) and (2)(iii) define very limiting structural scenarios for commercial real estate loans. Point (2)(ii) refers to the borrower's contribution in the form of cash or unencumbered marketable assets and does not refer to the borrower's contribution in the form of the value of the land in the project. Often the borrower's contributed capital is reflected in the land in a project and not necessarily all cash or unencumbered marketable securities. Point (2)(iii) states that the capital must be contractually required to remain in the project throughout the life of project.

Sections (2)(ii) and (2)(iii) as written will result in a substantial portion of ADC commercial real estate projects not secured by one- to four-family residential property to be categorized as HVCRE. If this is the intent, the definition would be

simplified by removing these items as they rarely occur. If it is the intent of the Agencies to include *some* ADC commercial real estate projects not secured by one- to four-family residential property, items (2)(ii) and (2)(iii) should be removed or rephrased.

We highlight these two points to illustrate the full impact of the current HVCRE definition. The revised definition differs from that provided in the ANPR and results in a much larger portion of commercial real estate exposures to be categorized as HVCRE. The study "Loss Characteristics of Commercial Real Estate Loan Portfolios," June 2003 by Bradford Case of the Board of Governors of the Federal Reserve System noted the recommendation of the Board staff to include exceptions for commercial real estate loans with "substantial equity" and "pre-sold/pre-leased." We urge the Agencies to reconsider their definition and exclude stabilized commercial real estate from the definition of HVCRE.

**3. Reporting of PD and LGD pre- and post-CRM**

The NPR states that a bank may either adjust the PD or LGD of a wholesale exposure to reflect the risk mitigating effects of a guarantee or credit derivative. The NPR further specifies that a bank may choose either a PD substitution or a LGD adjustment approach (in certain instances a double default treatment is also appropriate).

Implementing this guidance requires limited adjustment to existing risk management practices and reporting systems. For instance, a corporate or personal guarantee of a particular credit often results in lower risk of default or loss to the bank. Accordingly, exposures with a corporate or personal guarantee are assigned a lower default or loss rate. This is reflected in current ALLL and economic capital allocation policies and procedures.

In contrast to NPR guidance, the Regulatory Reporting Requirements schedules imply separating the obligor's risk of default and the guarantor's risk of default as if the bank had lent to the customer without the guarantee. This would require significant adjustments to existing risk management practices and reporting systems. For example, we interpret the instructions such that loans with corporate, personal or government guarantees to be reported before and after CRM. We do not think that this distinction in the reporting of the exposures will be useful information for users of the schedule. The loan and the guarantee are tightly connected and should not be reported separately. Similarly, an investment security with an insurance wrap should be reported based upon how the security is traded in the market; that is with the insurance wrap.

The only case where we believe that the reporting of CRM is useful to report separately is when the CRM has been purchased separately from a third party. This would include credit default swaps and other similar forms of CRM.

#### **4. Calculation of Capital for Defaulted Assets**

The NPR provides a method for calculating risk-weighted assets for wholesale exposures to a defaulted obligor using two calculations. Banks would have to compare the two amounts:

*(i) The sum of 0.08 multiplied by the EAD of the wholesale exposure plus the amount of any charge-offs or write-downs on the exposure; and (ii) K for the wholesale exposure (as determined in Table C immediately before the obligor became defaulted), multiplied by EAD of the exposure immediately before the exposure became defaulted. If the amount calculated in (i) is equal to or greater than the amount calculated in (ii), the dollar risk-based capital requirement for the exposure is 0.08 multiplied by EAD of the exposure. If the amount calculated in (i) is less than the amount calculated in (ii), the dollar risk-based capital requirement for the exposure is K for the exposure (as determined in Table C immediately before the obligor became defaulted), multiplied by the EAD of the exposure.*

This comparison ensures that a bank does not receive a capital benefit when an exposure moves from non-default to default status. While this is a valid concern, this method results in overly burdensome reporting requirements. It requires banks to perform very complex calculations and multi-period comparisons at an account level, further putting a strain on an already tight reporting timeline.

We suggest the Agencies adopt a more simplified approach. One such approach is to treat defaulted wholesale exposures like defaulted retail exposures for capital allocation purposes. Using this method, banks would use 8% of EAD.

#### **5. Boundary between Credit and Operational Risk**

The NPR proposes to treat losses that are related to both operational risk and credit risk as credit risk losses for purposes of calculating risk-based capital requirements. The proposed exception to this rule is retail credit card fraud losses, which may be treated as operational losses.

We suggest that the boundary between credit and operational risk be expanded to permit banks to be consistent with their internal risk management practices. While the general separation between credit and operational risk suggested in the NPR is reasonable, it would be appropriate for the agencies to allow the banks to treat fraud losses on overdrafts and settlement accounts as operational risk losses to remain consistent with their internal models. In this way banks will be able to avoid the burden of having to develop two sets of models: one for Basel II compliance and the other one for internal use. This would be consistent with bank's risk management practices and support the use test requirements of the NPR.

## II. Disclosures

### 1. Regulatory Reporting Proposal

#### *Reporting for Prior Period Lookback portfolios*

We urge the Agencies to not collect the lookback information as proposed at this time. The information on transitions between ratings segments is used for internal modeling of credit risk of the portfolios. The AIRB approaches are not dependent upon this information. The information that is reported each quarter on the segmentation of the portfolios in the schedules provides the information required to analyze the changes in the portfolio composition and the corresponding capital allocations.

The transition matrices are needed for a "full-models" approach, but a "full-models" approach is not what is utilized in the current proposal. In our view, given the substantial levels of disclosure already included in this NPR, this additional level of information should not be required.

#### *Alternative Reporting Treatment for Wholesale and Retail Portfolios*

We agree with the Agencies' counterproposal to allow banks to report Schedules C – R according to their own PD (internal rating grades) reporting bands.

#### *Disclosure of Schedules A and B*

We agree with the Agencies that it is reasonable to make Schedules A and B available to the public once a banking organization's Basel II process has been approved for use by the regulators.

### 2. FFIEC 101 Reports

#### *General comments*

Pillar 3 table disclosures and FFIEC 101 regulatory reporting schedules are a significant change and a substantial addition to current reporting in both qualitative and quantitative reporting requirements.

There is significant redundancy between the proposed Pillar 3 table disclosures and FFIEC 101 schedules coupled with the requirement that FFIEC 101 schedules are to be filed for the top tier bank holding company as well as their subsidiary depository institutions. Most of the FFIEC 101 schedules are confidential, with which we agree, while all of the Pillar 3 tables are public. In addition, the quarterly frequency of many of the Basel II quantitative disclosures is not consistent with the frequency of the related risks changing as evidenced by current filing requirements. Examples include maturities and geographic and industry concentration disclosures which are currently only required annually by the SEC in the Form 10-K. We believe that annual reporting provides sufficient information to the readers of the reports.

In addition, the Agencies should also address the redundancy between the proposed Pillar 3 table disclosures and FFIEC 101 schedules and reassess the granular nature of the FFIEC 101 schedules.

We suggest that the Agencies include a glossary of terms in the instructions for the Schedules. We would like to see the glossary include definitions of corporate, bank and sovereign, past due and impaired loans and the terms used in Schedule U. For further clarification, we would also like to see examples included in the glossary definitions.

We recommend the following adjustments to the timing of the reporting:

- Given the significant increase in proposed reporting requirements once Pillar 3 disclosures become effective, the Agencies should allow at least 60 days for the filing of all Basel II reporting, including FFIEC 101 Schedules A through V.
- If the Agencies ask that banks report operational losses on an event basis, as we suggest later in this appendix, then we would recommend that the operational loss event data be permitted to be reported on a quarter lag basis. We find that the reporting of operational losses grouped as events requires additional time to collate the loss data into events.
- During the parallel run period, Schedules A through V should not be required earlier than 90 days following quarter-end.

#### *Schedule B lines 29 - 30*

To promote consistency in reporting, we recommend the Agencies provide additional clarification including examples regarding the distinction between line item 29 and line item 30 on Schedule B. Our initial interpretation of the proposed guidance is line item 29 would include assets risk-weighted by regulatory rule other than the advanced approach and line item 30 would include assets where it is not cost effective to implement Basel II due to a lack of statistical basis for an internal rating on the portfolio.

Additionally, we recommend the Agencies re-title line item 30 "Immaterial Exposures" on Schedule B. The need for this category is based on the factual realities of cost effective implementation of Basel II and the availability of sufficient data to estimate parameters, not solely on immateriality considerations. This line item may include such items as credit exposures resulting from recent merger and acquisition activity, from the development of new products, and from portfolios for which it is not statistically valid or cost-effectively feasible to calculate risk-weighted assets on the AIRB method. The aggregate amounts of such credit exposures may exceed traditional benchmarks of immateriality. We suggest that line 30 be named other risk-weighted assets as a more appropriate description.

#### *Schedules L – N Residential Mortgages*

The instructions for these proposed schedules require calculating Loan-to-Value (LTV) ratios by combining junior liens with first lien exposures. It is not a current risk management practice to combine junior lien exposures when determining LTV ratios for first mortgage products as required by Schedule L.

The requirement to provide the EAD of accounts with updated LTV results in banks having to collect the originating LTV as well as track updated LTVs. This information is not consistently tracked within banking organizations for risk management purposes. In



addition, such information may not be readily available and will be difficult to collect. Furthermore, given the collection of this data is not currently utilized across all business units within banking organizations, aggregated data would likely be incomplete and misleading.

We recommend the Agencies not require that first and second liens be reported on a combined basis.

#### *Schedule V Operational Risk*

We agree line items 1 and 2 are appropriate for public disclosure. However, we recommend that line items 3 through 7 be classified as confidential disclosures to the Agencies. We believe that disclosing this information will result in competitive disadvantage.

Additionally, we recommend that the definition of losses reported in schedule V, items 11 – 15, be revised to “loss events.” Collecting information regarding loss events is consistent with the NPR and the data utilized for capital-modeling purposes because a single “operational loss event” may have a number of associated “operational losses.” The collection of “losses” instead of “loss events” would result in inconsistent data that could not be reconciled between Columns A and B of the schedule, because Column A requests data used for capital modeling purposes, thus incorporating acceptable loss-event-data collection thresholds, while Column B has no such limitation.

### **3. Materiality**

We agree with the Agencies’ statement that the materiality concept will apply to these proposed Basel II disclosures; however, we recommend the Agencies clarify that this means consistency with existing practice for financial reporting. This will facilitate the consistency of materiality for all public disclosures.

Given the granular nature of Basel II coupled with the fact that FFIEC 101 Wholesale and Retail Risk Weighted Assets Schedules (C – H (Wholesale) and L – R (Retail)) allow for the exclusion of immaterial exposures from utilization of one of the Basel II formulas, we assume Pillar 3 table requirements that are immaterial from a financial reporting perspective to the Company, will not have to be disclosed as part of our Pillar 3 table disclosures.

### **4. Pillar 3 Tables in the NPR**

*Table 11.4(b) – (e)* – The terminology “major types of credit exposure” is unclear as to whether the disclosures should follow balance sheet or Basel II formula classifications. Balance sheet classifications would be consistent with current SEC and regulatory balance sheet disclosures, but seem to conflict with the FFIEC 101 schedules which are Basel II formula based. Basel II formula classifications would be duplicative of FFIEC 101 Schedule B balance sheet and undrawn amounts. In either case, these Pillar 3 disclosures appear to be duplicative of current SEC, FR Y-9 and Call reporting requirements and proposed FFIEC 101 schedules.

*Table 11.4(c), (g) Exposures & Allowances by Geography* – The level of granularity required for geographic distribution of exposures is not clear. The Company plans to report on the same geographical regions that are reported annually in its Form 10-K. With respect to the amounts of allowances related to each geographical area, the guidance indicates it should be disclosed if practicable. The Company does not determine the allowance for loan losses by geography as this does not provide better analysis of the adequacy of the allowance for credit losses on a legal entity basis and, as such, does not plan to disclose this information. We would like clarification that this will not be a requirement imposed during the regulatory examination process.

*Table 11.4(d), (f) Exposures by Industry or Counterparty Type* – The guidance is unclear on how to construct a disclosure by counterparty. Is the expectation of these Pillar 3 disclosure requirements by industry, counterparty type or both? Is the term industry relative to loans and counterparty relative to derivatives? Exposure by industry is currently reported in the Form 10-K SEC reporting disclosures. Distribution by industry does not change materially quarter over quarter and is an annual SEC reporting disclosure requirement. We believe that annual reporting is sufficient and suggest the Agencies revise their reporting frequency to annual for this disclosure.

*Table 11.4(e) Remaining Contractual Maturity Breakdown* – Remaining contractual maturity does not materially fluctuate from quarter to quarter. The SEC requires this disclosure on an annual basis. We believe that annual disclosure is sufficient.

*Table 11.4(f), (g) Impaired and Past Due Loans* – The definition of past due loans and impaired loans needs further clarification. We request greater specificity of the definitions in light of current accounting and regulatory guidance.

*Table 11.4(g) Past Due Loans By Geography* – Past due loans broken down between 30 – 89 days and 90 days or more and still accruing is already disclosed quarterly in the FR Y-9C and Call reports on Schedule N. We believe that reporting past due exposures by geography is more detailed than necessary, and suggest that the current reporting disclosures for past due loans continue without expansion by geography, which increases the reporting burden with limited benefits for the users of the financial information.

*Table 11.5(a) Qualitative Credit Risk Management Disclosures* – The qualitative disclosure requirements for internal rating systems and risk parameters should allow banks to reserve the right to avoid disclosing proprietary information. We believe that it is appropriate to provide general descriptions of the rating system, but the specifics of the rating system should be protected.

#### *Certification Requirements*

We ask that the Agencies provide additional clarification of the nature and scope of the certification requirements of the Pillar 3 disclosures.

### III. Other Comments

#### 1. Implementation for Merged or Acquired Banks

The NPR requires that a core or opt-in bank that acquires a core or opt-in bank to submit an implementation plan for using the advanced approach within 30 days of consummating the merger or acquisition. We recommend that this time period be extended to at least 90 days, or longer. There are many conversion plans that must be developed during a merger. The risk management and reporting systems used in the implementation of the NPR require the coordination of all source applications into the risk systems. The plans for the source systems are unlikely to be fully developed within 30 days. Because of the dependency for applications system conversion plans to be developed prior to the development of the plan for the regulatory capital systems, we believe that 30 days is an insufficient time period.

#### 2. 10 Percent Aggregate Capital Reduction Rule

The NPR has a provision where the Agencies will adjust the capital requirements of the banks that use the rule.

*for the U.S. banking system as a whole, aggregate minimum regulatory capital requirements that are not a material reduction from the aggregate minimum regulatory capital requirements under the general risk-based capital rules.*

We would like the Agencies to consider that there are many factors at work which may prudently change the capital requirements from current levels. These factors include:

- The choice of rating methodology. Some banks have credit rating systems that are more point-in-time versus other bank's rating system which are more through-the-cycle. If the Agencies adjust capital levels during a favorable portion of the credit cycle to maintain flat system capital levels, then banks with a point-in-time rating system may be advantaged over banks with a through-the-cycle rating system.
- Ratings migration. As the banking industry moves through the credit cycle, there will be changes in the ratio of upgrades versus downgrades. This will have a portfolio effect of adjusting capital levels up and down. This volatility in the ratios of upgrades and downgrades is normal, but arbitrarily countering the favorable effects of increased upgrades versus downgrades by raising general capital levels is counterproductive to sound governance practices.
- Competitive considerations. Applying an industry level capital requirement based on the general risk-based capital rules will broadly offset the more risk sensitive framework developed in the NPR. Banks over the years have used securitization as a means to adjust capital held under the regulatory rules closer to the economic capital requirements. Using a broad adjustment factor at the industry level to raise capital levels leaves banks without a means to adjust regulatory capital closer to economic requirements. This will in the long run further accelerate the banking industry's decline in the share of the financial services market. Portfolio lending at banks will in the long run be discouraged by this broad capital adjustment lever.

We urge the Agencies to discontinue the 10 percent aggregate capital reduction rule. The Agencies should consider the impact of the changes in the capital requirements on an industry basis and using the reported information collected from the banks to analyze the banking industry's collective capital requirements through the credit cycle. The Agencies should follow similar practices that are required of the banks in an internal capital adequacy assessment process (ICAAP), but applied on an industry basis. Only through an assessment of the industry's capital requirements will the Agencies be able to assess the collective capitalization of the industry. Using the standard of the current general risk based capital rules is not consistent with the intent of developing a more risk sensitive capital framework.

### **3. Scope of Application**

We urge the Agencies to eliminate the scope of application in the NPR or at a minimum raise it substantially. We do not believe that the current scope of application should be mandated upon any bank. The international version of Basel II does not include this type of mandate. The incentive should be placed in the structure of the rule to permit increasingly risk sensitive capital measurements.

If the Agencies maintain the leverage ratio requirements and the 10 percent aggregate capital decline requirement, then the enhanced risk sensitivity of the advanced approaches have been effectively eliminated. The original purpose of the Basel II Accord was to improve risk management and establish a more risk sensitive capital framework. If the more risk sensitive capital framework is eliminated, then one of the two primary reasons for the new rules is removed.

The enhanced risk management framework is well underway at many large banks. These banks have leveraged their economic capital processes, enhanced their data collection of risk information, established new processes for measuring operational risk and improved their ICAAP. In many ways the Agencies have already achieved the goal of Basel II's enhanced risk management. These improved risk management practices will continue whether banks adopt the advanced approach for capital or use the standardized or current capital rules. Therefore, requiring the banks to run an expensive process of certification and reporting for a revised regulatory capital framework which results in capital requirements which cannot decline is an unnecessary burden upon the industry.

### **4. Risk Weight for Fixed Assets**

The NPR asks if the 100% risk weight assigned to other assets is appropriate. We believe that the operational risk capital assigned to "damage to physical assets" will appropriately include fixed assets. Assigning a 100% risk weight to these assets will provide a duplication of capital requirements. Either damage to physical assets should be excluded from operational risk or fixed assets should not receive the 100% risk weight. We suggest that including fixed assets into operational capital is the more logical choice.