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Regulation Comments
Attention: No. 2006-33
Chief Counsel's Office
Office of Thrift Supervision
700 G Street, NW
Washington, DC 20552
USA

05.03.2007 D/000519

Subject: Comment on Risk-Based Capital Standards: Advanced Capital Adequacy Framework and Market Risk; Proposed Rules and Notices. Board Docket No. R-1261 and R-1266, OCC Docket No. 06-09 and No. 06-10, FDIC RIN 3064-AC736 and RIN 3064-AD10, OTS No. 2006-33 and No. 2006-04.

Dear Sir/Madam,

This letter constitutes the response of the European Commission to the call for comments made by the four agencies ("the Agencies") in relation to the proposed rules on risk-based capital standards, advanced capital adequacy framework and market risk.

The European Commission welcomes the opportunity to comment on the Notices of Proposed Rulemaking ("the NPRs") on risk based capital standards to implement the Basel Revised Capital Framework ("the Revised Framework")¹ for banks in the United States. The European Commission is commenting on the NPRs since the differences between the proposed rules and the Revised Framework may lead to additional, and unnecessary, regulatory burden for EU banks that are active in the US and US firms that are active in the EU.

This letter has been seen by/commented on by the Finance Ministries of the 27 Member States of the European Union, associations representing European banks, and individual companies. These comments are supported by the European Banking Committee, representing the Finance Ministries of all 27 Member States of the European Union.

We would be happy to discuss these and other issues that the US Agencies deem relevant in terms of implementing a true global capital standard.

¹ Basel Committee on Banking Supervision- International Convergence of Capital Measurements and Capital Standards: A Revised Framework Comprehensive Version (June 2006)

1. General comments

(a) Consistency with the Revised Framework

We would like to emphasise that in all areas it is important for the Agencies to ensure that the US rules are as consistent as possible with the Revised Framework, so that regulatory burdens are minimised both for EU firms operating in the US and US firms that are active in the EU. In response to the questions in the NPR where you seek comment on which approaches to take, we would encourage you to ensure that the approach is consistent with the Revised Framework including provisions on market risk.²

In addition, we suggest that the Agencies make the full range of approaches for operational risk and for credit risk, as set out in the Revised Framework, available to ensure that banks use a more risk-sensitive approach than the existing rules, without creating competitive distortions or undue regulatory burdens. Furthermore, for many foreign banking groups, it may not be practicable for various reasons to implement the IRB approach across all asset classes and business units. For example, we would like confirmation that exposures in non-significant business units as well as asset classes within a particular business unit that are immaterial in terms of size and perceived risk profile are exempted from the IRB framework³. In these cases the Revised Framework's standardised approach should be applied⁴.

This letter outlines key areas⁵ (see section 2 below) where differences between the NPR and the Revised Framework text may lead to additional costs to EU firms from an operational standpoint. In particular, we comment on those proposed rules that may have negative effects for EU firms in terms of dual systems and duplication of costs. We also believe that these differences are unlikely to provide any extra benefit in terms of enhanced risk management, or the level or allocation of risk-based capital, and may prevent firms from operating a coherent group wide risk management and capital framework.

(b) Timing

We recognise the progress that has been made with implementing the Revised Framework for internationally active banks in the US. We respect the need for the agencies to implement the Revised Framework through your domestic process.

However, we believe it is now important that the Agencies follow as closely as possible the proposed timetable for implementation of the Revised Framework. Further delays in implementation will result in further burden for EU banks applying the most advanced approaches at a consolidated level. In supporting the option to use the Standardised approaches (see above and also our comment letter on Basel "IA"), the European Commission

² For example as regards the NPR on Market Risk:

- Question 5 – Agencies should ensure that the exclusion of residual securitisation positions and the market maker exemption and the conditions to use that exemption are consistent with the Revised Framework §712 (ii) and 718 (xcv).
- Questions 9 and 13: To ensure an international level playing field, the agencies should confine the grandfathering of the partial specific framework until 2010 consistent with the Revised Framework: Footnote 113 and paragraph 718 (xcii) clarify that the available fallback method proposed for banks unable to develop an internal model to capture incremental default risk by 1 January 2010 is sufficient.

³ BCBS: A Revised Framework, Comprehensive version, June 2006 §259.

⁴ As suggested in the United States Government Accountability Office Report to Congressional Committees (GAO-07- 253) on Risk-Based Capital (February 2007).

⁵ Definitions of default, risk parameters and securitisation; the scope of application for Bank Holding Companies; and the use of AMA modelling at sub-group or subsidiary level.

acknowledges the challenge that this may pose in terms of allowing the Agencies to meet the timetable for implementing the Revised Framework. However, we strongly encourage the Agencies to maintain the existing timetable for the advanced approaches in any case, even if this means that the Standardised approaches become available later than the advanced approaches.

If the Agencies consider the introduction of the Standardised approaches to be appropriate, then we would encourage a pragmatic and practical approach to transitional arrangements to facilitate such changes. Allowing banks that may seek to use the Standardised approaches to remain on either Basel I or Basel IA during a transitional period would allow for a seamless introduction of the Standardised approaches, whilst ensuring that the implementation of the advanced approaches under the Revised Framework are not subject to further delay.

2. Technical Comments

We believe the key areas of divergence between the NPRs and the Revised Framework relate to definitions of default, risk parameters and securitisation; the scope of application for Bank Holding Companies; and the use of AMA modelling at sub-group or subsidiary level. These divergences may lead to substantial additional, and unnecessary, regulatory burden and costs for EU banks that are active in the US and for US firms that are active in the EU.

(a) Definition of Default

The definition of default in the NPR for corporate exposures differs from that in the Revised Framework in the following ways:

The proposed rules define default for wholesale exposures as "any wholesale exposure that 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 held-for-sale, available for sale, trading account or other reporting category"⁶. The Revised Framework takes a more flexible approach to what constitutes a material credit loss for the purposes of defining default.

This divergence in the definition impacts on the assumptions behind the calculation of PD, LGD and EAD and - since the two definitions will need to be used within one bank - there will be a double implementation and validation effort by an EU institution that has a subsidiary in the US and by a US institution that has a subsidiary in the EU. The cost in terms of new systems for the calibration when using a second definition of default would be very high for firms, with no significant extra benefit for internal risk management.

Moreover, divergences in the definition of default will lead to problems in complying with the use test requirement that parameters used for regulatory purposes are also used for internal purposes. Since only one definition of default will be used centrally, banks will, therefore, be unable to comply with the use test in the EU and US simultaneously.

The divergences in the definition of default may also have a negative impact on risk management and corporate governance. Internationally active banks typically gather data from their subsidiaries along global business lines, rather than by country or entity because this is how risk is managed on a daily basis. The divergence in definitions of default will make this harder to do, thus inhibiting effective risk management, which is what the Revised Framework intends to promote. Many internationally active firms run their businesses based

⁶ 71 Fed. Reg. 55846

on these metrics. If they are required to use different metrics in different jurisdictions, then consistent management and governance across the group becomes a more difficult challenge. Furthermore, the divergence in definitions will mean that firms may not be able to comply with the requirement to adopt one single rating per counterparty on a bank wide basis and the one obligor rule.

Recommendations:

- We suggest that the Agencies adopt a definition of default consistent with the definition in the Revised Framework.

(b) Exposure at Default ("EAD")

The NPR defines a bank's EAD as "the bank's carrying value for the exposure (including net accrued but unpaid interest and fees) less any allocated transfer risk reserve for the exposure."⁷ This is not aligned to the Revised Framework which states that in the case of EAD "all exposures are measured gross of specific provisions or partial write-offs"⁸.

Although there is some correction provided for in the Expected Loss (EL) calculation, the effects of using the two differing approaches are not fully neutralised. More importantly, the divergent approach proposed in the NPR will have significant systems implications for banks, as they will be obliged to use and calculate different data fields for compliance with both the proposed US rules and other regulations in those jurisdictions which are aligned to the Revised Framework.

Recommendations:

- We recommend that the definition of EAD, and the consequent EL calculation, be aligned to the Revised Framework.

(c) Definition of Asset Securitisation

According to the proposed rules on traditional securitisation, one of the criteria for excluding securitised exposures from risk weighted assets is if "the transfer is a sale under the US General Accepted Accounting Principles ("US GAAP")"⁹. The use of US GAAP accounting principle may create a structural difference in the market and materially impact the location of transactions (both for originators and investors). This is significant because internationally active banks may need to reconcile transactions located in different jurisdictions, based on different definitions, when they produce consolidated data. The same principle holds true for synthetic securitisation, since the NPR refers only to the criterion of credit risk transfer without any recognition given to the concept of significance.

Recommendation:

- Align as much as possible with the operational requirements set out in the Revised Framework for both traditional and synthetic securitisations (i.e., by including the concept of significant risk transfer).

⁷ 71 Fed. Reg 55849

⁸ BCBS: A Revised Framework, Comprehensive version, June 2006 §308

⁹ 71 Fed. Reg 55883

(d) Scope of application for Bank Holding Companies

Possible exemptions

The NPR states that a Bank Holding Company ("BHC") (including a BHC that is owned by a foreign banking organisation) "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"¹⁰.

In our view, it would be extremely costly for foreign owned BHCs to adopt this rule, which will oblige the adoption of the advanced approaches not for capital calculations, but simply for the purposes of meeting this rule. In particular, we consider that the requirement that these BHCs also make Pillar 3 disclosures at the BHC level to be unduly burdensome. We consider that in many cases such Pillar 3 disclosures may lead to market confusion rather than market discipline, as many transactions at the BHC level are undertaken for intra-company organisational reasons.

Suitability for all structures

The NPR states that the depository institution (DI) subsidiary of a BHC, as defined above, would also "be a core bank and would be required to adopt the advanced approaches (unless specifically exempted from the advanced approaches by its primary Federal supervisor) and meet the minimum capital ratio requirements"¹¹. In many cases, it is our understanding that the majority of the consolidated assets of such BHCs may be attributable to securities firms and not directly to the DIs. Whilst we acknowledge that this proposed rule seeks to minimise the incentives to structure BHC assets in a way that minimises capital requirements, in many cases the decision to allocate assets in DI or non-DI subsidiaries is made to meet business objectives, rather than to achieve capital arbitrage.

Clarification of scope

The NPR states that a "top-tier U.S. BHC, and its subsidiary DIs, that is owned by a foreign banking organization also would be subject to the same threshold levels for core bank determination as would a top-tier BHC that is not owned by a foreign banking organization"¹². It is our understanding that this would mean that intermediate level foreign banking organisation ("FBO")-controlled BHCs would not be subject to the same threshold levels for core bank determination. If our interpretation is incorrect, then we consider that imposing the core bank criteria to intermediate level BHCs would be unduly burdensome.

Recommendations:

- We would encourage the Agencies to ensure that BHCs (including a BHC that is owned by a foreign banking organisation) that meet the conditions in Federal Reserve SR letter 01-0122 and are core banks, be exempt from the requirement to compute and report their capital ratios in accordance with the advanced approaches, and to make the associated Pillar 3 disclosures.

¹⁰ 71 Fed. Reg 55841

¹¹ 71 Fed. Reg 55841

¹² 71 Fed. Reg 55841

- To prevent undue burden on US subsidiaries of EU banks, we would suggest that BHCs and DI subsidiaries should only be classified as core banks if the majority of the BHC's consolidated assets are attributable to DIs or the DI subsidiaries meet the thresholds for a core bank on a consolidated basis.
- We encourage the Agencies to clarify that the threshold levels for core bank determination apply to top-tier BHCs only.

(e) Operational Risk

The proposed rules on operational risk¹³ include a number of departures from the Revised Framework that will impose important cost on internationally active banks. This is due mainly to the following:

- internationally active banks that do not use an AMA at group level would be forced to implement one for their US operations in order to be able to "opt in"; and
- internationally active banks that use an AMA at group level may not be able to make use of their data and systems and would be forced to develop costly US-specific solutions.

For medium sized and smaller subsidiaries of foreign banks in the US, these costs are likely to prove prohibitive. They may then be unable to "opt in" to the advanced approaches although they would be capable of using IRB for credit risk. This runs counter to the Revised Framework's objective to enable banks to adopt the more advanced approaches where possible, in line with banks' abilities.

For the larger subsidiaries of foreign banks in the US that represent "core" applicants, the additional costs will effectively run counter to the Revised Framework's objective of aligning supervisory requirements to internal risk management. These banks would build US level AMAs that they do not use for their internal risk management and, as required by their consolidating supervisors, will use the group level AMA for consolidated purposes. The "use test" requirement that parameters used for regulatory purposes are also used for internal purposes will then be impossible to comply with. In this last sense the provisions on use of AMA and IRB in the NPRs raise the same problem for banks.

Recommendations:

- To ensure that banks can utilise and share consistent internal and external loss data and scenario analyses across jurisdictions; the separate definition of "operational loss" should be removed and "operational risk exposure" should be defined as the 99th percentile of the distribution of operational risk over a one-year horizon. This simplification would at the same time achieve that operational risk is not required to be measured as the risk of accounting losses but that banks could use concepts of loss along with their internal practices.
- In line with the continuum of operational risk measurement approaches in the Revised Framework that banks are free to choose from, all banks, including BHCs, should be able to adopt an "alternative operational risk quantification system", such as the Revised

¹³ 71 Fed. Reg 55899 - 55901

Framework's Standardised approach or an allocation approach, the latter subject to the terms and conditions of the Revised Framework itself. The fact that an entity constitutes a BHC does not necessarily imply that it has sufficient loss data to run an AMA for all business lines and loss event types, in particular if its business activities are focussed on few business lines and/or if it is not possible for it to utilize (world-wide) group-level resources.

- The use of allocation mechanisms should not be subject to more stringent conditions than those set out in the Revised Framework. In particular, operational risk capital allocation should not be excluded if the group includes (foreign) investment firms.

We hope that the comments that we have put forward will be of assistance to the Agencies in the further work on the development and finalisation of the implementation of the Revised Framework. As indicated earlier, the European Commission stands ready to discuss, or further explain, the comments set out in this letter, and to work with the Agencies in a co-operative manner to facilitate the timely, consistent application of the Revised Framework internationally.

Please note that we have sent the same response to the Office of the Comptroller of the Currency, the Federal Reserve System and the Federal Deposit Insurance Corporation.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'Charlie', with a long, sweeping horizontal stroke extending to the right.

Charlie McCreevy