MEMORANDUM

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TO: Public File

FROM: Karen Osterloh, Special Counsel

DATE: August 31, 2006

RE: Basel II NPR
Summary of OTS meeting

Attendees

On July 14, 2006, the following individuals met at OTS headquarters in Washington, DC to discuss the Basel II NPR:

WAMU	John Robinson Alison Watson Bill Longbrake	OTS	John Reich Scott Albinson Grovetta Gardineer Michael Solomon Fred Phillips-Patrick Karen Osterloh
JPMC	Adam Gilbert Naomi Camper		
Wachovia	Jim Burr Greg Norwood		
Citigroup	Jim Garnett		
Barnett Sivon & Natter, P.C.	Jim Sivon		

Summary of Discussion

While the four banks support the original Basel II objectives of an international risk-sensitive capital regime that would create a level playing field, they believe that the U.S. Basel II NPR released by the FRB ("the draft NPR") undermines the objectives by imposing a variety of conservative adjustments compared to the International Accord. The four banks opined that the following aspects of the Basel II NPR were problematic:

- The agencies' position that a 10% or greater decline in aggregate minimum required risk-based capital is a material reduction warranting modifications to the supervisory risk functions or other aspects of the framework.
- The fact that the proposed transitional floor periods and transitional floor percentages diverge from, and are more restrictive than, the floor periods and percentages in the Basel II Accord.

- The fact that core and opt-in banks would continue to be permanently subject to the existing tier 1 leverage ratio requirement.
- The proposed application of a "scaling factor" of 1.06 to credit risk weighted assets.
- The proposed definition of default for wholesale exposures, which states that a default occurs when a bank has incurred a credit-related loss of 5 percent or more of the exposure's initial carrying value.
- The proposed loss given default (LGD) provisions, which require a bank to calculate two LGDs -- one based on average economic loss over a mix of economic conditions and another based on economic loss during economic downturn conditions.
- The proposed risk-weights for private equity exposures, which are more conservative than risk-weights in the Basel II Accord.
- The failure to include the adjustment for small and medium sized enterprises from the Basel II Accord. Under this adjustment, a loan to a small- or medium-size enterprise would receive a lower risk weight than a loan with the same risk parameters made to a larger firm.
- The rule's general emphasis on stressed risk parameters.
- Portfolio hedging practices are not adequately recognized in the Basel II NPR.

The banks opined that these provisions raise the following issues.

- Inappropriate risk sensitivity. The four banks indicated that the NPR imposes a level of conservative calibration in the Pillar 1 calculation that inappropriately changes the true measure of risk and many such features are different than the International Accord. The banks urged the agencies to adopt a rule that more appropriately reflects the drivers of risk and appropriate portfolio management.
- Competitive inequality. The banks argued that the NPR, if finalized, would place U.S. banks at a competitive disadvantage since their capital requirements would always be higher than their competitors for the same assets. These inequalities would exist between U.S. banks and banks in other jurisdictions that follow the Basel II Accord more closely, and would also exist between U.S. banks and U.S. investment banks, whose rules more closely track the Basel II Accord.
- Divergence from best industry practices and cost/benefit issues. The banks argued that the regulatory regime in the NPR deviates in meaningful ways from internal risk management practices. Rather than implement a regulatory regime that converges with internal practices, the banks argued that they would be required to invest a substantial amount to produce a "compliance measurement". The banks also noted that the highly prescriptive nature of the proposed rule and the divergence from many common risk measurement practices may make it difficult to demonstrate that they comply with the use test in the Basel II NPR.

While the banks indicated that their top priority is to persuade the agencies to address the ten items identified above, they also argued that U.S. banks should be permitted alternative methodologies, which may include the International Standardized Version as modified in November 2005. Therefore, the banks urged OTS and the other agencies to make the

standardized approach available to all banks in the U.S. either through the Basel II rulemaking process or through the upcoming Basel IA NPR.

OTS noted that studies have indicated that capital requirements would increase under the standardized approach due to the additional operational risk capital requirement. OTS asked what the banks saw as the main advantages of the standardized approach. The banks indicated that the standardized approach would be a less costly compliance exercise and noted that any one of the approaches (the Basel II NPR approach, the standardized approach, and Basel IA approach) might appeal to a particular bank given its circumstances. They also indicated that the standardized approach might be an appropriate way for a particular bank to gradually move toward the implementation of the advanced approaches in the Basel II NPR.

In response to OTS concerns whether the standardized approach could be implemented within an appropriate time frame, the banks indicated that because the U.S. regulators were part of the review process to approve the International version of the Standardized Version, they believed the rules could be drafted expeditiously provided the standardized approach was adopted without the exercise of significant U.S. national discretion.