THE FINANCIAL SERVICES ROUNDTABLE

Impacting Policy. Impacting People.

1001 PENNSYLVANIA AVE., NW
SUITE 500 SOUTH
WASHINGTON, DC 20004
TEL 202-289-4322
FAX 202-628-2507

E-Mail info@fsround.org
www.fsround.org

Communications Division
Public Information Room
Mail Stop 1-5
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, DC 20219

Re: Docket No. 06-09

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, DC 20551

Re: Docket No. R-1261

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W. Washington, DC 20552

Re: No. 2006-33

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corp.
ATTN: Comments/Legal ESS
550 17th Street, N.W.
Washington, DC 20429

Re: RIN 1550-AB56

Re: Notice of Proposed Rulemaking on Risk-Based Capital Standards: Advanced Capital Adequacy Framework

Dear Sir or Madam:

The Financial Services Roundtable[1] appreciates the opportunity to comment on the joint notice of proposed rulemaking to implement the Basel II Capital Framework in the United States.

I. Introduction

The Roundtable strongly supports the implementation of the Basel II Capital Framework in the United States. The Basel II Capital Framework, which U.S. and international regulators

[1] The Financial Services Roundtable represents 100 of the nation's largest integrated financial services companies. Roundtable members provide banking, insurance, investment products and services to American consumers and businesses. Roundtable member companies manage over $18.3 trillion in assets, have revenues in excess of $670 billion, and employ over 2.1 individuals.

agreed upon in June 2004, is intended to more closely align regulatory capital with economic risk. It also is intended to minimize the differences in regulatory capital requirements between different countries. Both of these are worthwhile goals.

Aligning regulatory capital to true economic risk will enhance the safety and soundness of our banking system. A risk-sensitive capital regime encourages institutions to develop and implement modern risk-mitigation techniques. A risk-sensitive regime also reduces artificial incentives for shifting assets off a balance sheet simply for capital purposes.

Minimizing the differences in regulatory capital requirements between different countries is particularly important for the members of the Roundtable that are active internationally. The harmonization of international capital rules ensures that differences in capital rules do not create competitive disparities in business transactions. Harmonization also reduces the potentially significant compliance costs that can be associated with different capital regimes in different countries

Unfortunately, the rule proposed by your agencies (the "Basel II NPR") is not the same as the Basel II Capital Framework. The Basel II NPR includes a variety of provisions that are not part of the Basel II Capital Framework. These provisions reduce the risk-sensitivity of the rule, place U.S. banking organizations at a competitive disadvantage to foreign banks, and impose sizable compliance costs on U.S. banking organizations. Additionally, the Basel II NPR is overly complex, especially for institutions with relatively simple portfolios.

The Roundtable recommends that the Basel II NPR be harmonized with the Basel II Capital Framework. Concerns over capital levels can be addressed through the retention of the leverage ratio during the transition period. Adjustments, if any, to the Framework should be made after it has been implemented, not before. We also urge you to permit U.S. institutions to select between alternative methodologies for compliance, including the Standardized approach, which is part of the Basel II Capital Framework.[2]

II. The Differences Between the Basel II Capital Framework and the Basel II NPR

The Basel II Capital Framework allows for some national discretion in the implementation of the Framework. The Basel II NPR, however, stretches this authority to the

[2] We also note that the proposal would require extensive disclosures of information on a wide range of data, including very specific information on credit quality, risk mitigation techniques, a bank's risk assessment processes, and numerous other factors. In order to avoid the unnecessary disclosure of confidential proprietary information, to prevent the misinterpretation of reported data, and to minimize regulatory burden, we urge the agencies to reconsider the need for and level of detail in the required disclosures. Additionally, we urge that the public reporting requirements be phased in gradually over the transition period as confidence is gained in the model output and usefulness of possible Basel II disclosures.

extreme. The following are the major differences between the Basel II NPR and the Basel II Capital Framework.

- Only One Compliance Option — The Basel II NPR applies the advanced approach for credit and operational risk only to the largest U.S. banking organizations. Under the Basel II Capital Framework, banks have a choice of compliance options, including the standardized approach.

- Delayed Start Date — The start date for the parallel run under the Basel II NPR is one year later than the start date under the Basel II Capital Framework.

- Longer Transitional Floors — The transitional floors in the Basel II NPR last three years and require affirmative approval to be lifted. Under the Basel II Capital Framework, the transitional floors last only two years, and then are lifted.

- Ten Percent Aggregate Floor — The preamble to the Basel II NPR states that U.S. regulators will treat a 10 percent decline in aggregate risk-based capital as a material reduction warranting modifications to the rule. No such requirement appears in the Basel II Capital Framework.

- Leverage Ratio — The Basel II NPR will be applied in conjunction with the existing leverage ratio requirement. Most foreign countries do impose such a requirement.

- Definition of Default — The definition of default in the Basel II NPR is not the same as the definition in the Basel II Capital Framework.

- Small- and Medium-Sized Businesses — Under the Basel II NPR, U.S. banking organizations would not receive a capital adjustment for loans to small- and medium-sized businesses. The Basel II Capital Framework does provide a lower capital requirement for such loans.

- Loss Given Default — The Basel II NPR requires U.S. banking organizations to calculate multiple loss given default (“LGD”) estimates. This is not the case under the Basel II Capital Framework.

- Equity Investments and Loans — The Basel II NPR imposes a more restrictive capital treatment for equity investments in a financial company that has material liabilities than does the Basel II Capital Framework.

Collectively, these and other differences between the Basel II NPR and the Basel II Capital Framework reduce the risk-sensitivity of the rule, place U.S. banking organizations at a significant competitive disadvantage to foreign banks, and significantly increase the costs of compliance with the rule.

The ten percent aggregate limit is particularly troublesome. It injects a significant degree of uncertainty into the risk-based capital regime. Since it is an aggregate limit, it subjects

institutions to modifications in the rule based upon actions beyond their control. Moreover, the manner in which the limit would be calculated and how it would be applied is not clear. A recent Report to Congress by the Government Accountability Office on Risk-Based Capital highlighted the problems associated with this particular provision:

> …. Regulators have not explained how they plan to calculate the 10-percent reduction in aggregate minimum regulatory capital compared with Basel I and what would happen if the 10-percent reduction was triggered, other than it will warrant "modifications to the supervisory risk functions or other aspects of this framework." Under one scenario, for example, aggregate minimum required capital could potentially fall by over 10 percent in an economy in which borrowers were very unlikely to default, triggering a reexamination of Basel II by federal regulators, according to the NPR. However, this 10-percent reduction might not be an indicator of a fundamental flaw in the Basel II framework but rather a cyclical movement that could be reversed in bad economic times – that is, if Basel II is intended to be on average equal to Basel I over the business cycle. But this interpretation is only one possible interpretation of capital neutrality. Alternatively, a 10-percent reduction could indicate a problem if average (i.e., through the cycle) capital requirements were falling significantly relative to Basel I capital levels during less favorable economic conditions…. Moreover, it is unclear what would happen if a 10-percent reduction relative to Basel I were triggered. For example, would banks have to recalibrate their models, would a floor be imposed, or would a multiplier be added, and how would economic conditions be factored into the determination process?[3]

III. The QIS-4 Survey Is Not A Valid Basis for the Changes to the Basel II Capital Framework Made in the Basel II NPR

The provisions in the Basel II NPR that do not appear in the Basel II Capital Framework were added in response to the QIS-4 survey. That survey, which was conducted in 2004, found an average reduction in minimum risk-based capital of 15.5 percent under Basel II for the nation's largest U.S. banking institutions. Thus, most of the changes were added to maintain capital levels at Basel II banks that are comparable to Basel I levels.

The QIS-4 survey is not a valid basis for the proposed changes. The QIS-4 survey was only a "best-efforts" exercise, conducted before any participant had been deemed to be Basel II compliant. Moreover, the survey was focused exclusively on Pillar I of the Framework, was based upon limited data, was conducted with little regulatory oversight, and was conducted during an economic period when capital would be expected to decline under a risk-based system.

Your own agencies have acknowledged the limitations of the QIS-4 survey. In a speech to the Institute of International Bankers on September 26, 2005, Federal Reserve Board Governor Susan Bies stated that "… [the] QIS-4 does not represent the final version of Basel II in the United States and we realize that bank data and risk-management systems required by

[3] GAO-07-253, pages 72 and 73.

Basel II are not yet fully developed and implemented as expected by the framework." Similarly, in testimony before the Senate Banking Committee in November 2005, Comptroller Dugan noted that "We have concluded that some of the weaknesses identified in QIS-4 are attributable to the fact that no "live" Basel II systems have been built – in large part because we have not yet fully specified all the requirements for such a system."

IV. An Alternative Approach

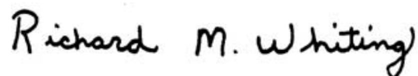
We believe there is a way to reconcile the goals of the Basel II Capital Framework and address concerns over capital levels. Our recommended alternative is three-fold.

First, while a leverage ratio that is not tied to risk can have the unintended effect of encouraging institutions to take on riskier assets, the retention of the leverage ratio during the transition period would ensure that institutions operate with a specific, and transparent, floor for regulatory capital. In other words, the continuation of the leverage ratio – alone – would obviate the need for the 10-percent aggregate floor, the longer transition period, and other provisions designed to address capital level concerns. We would recommend, however, that the need for the leverage ratio be reassessed after the transition period, and that during the transition period, the agencies consider adjustments to the level or components of the

Second, the Basel II NPR should be harmonized with the Basel II Capital Framework. This would promote consistency in international capital standards, and reduce compliance costs. Adjustments to the rule, if any, should be based upon "live" results from the transition period rather than the results of the QIS-4 survey. Additionally, to the extent possible, the requirements in the Basel II NPR should be scaled to reflect the complexity of portfolios.

Finally, U.S. banking organizations should be permitted to select the most appropriate methodology for compliance, including Basel IA or the standardized approach.

Sincerely,



Richard M. Whiting
Executive Director & General Counsel