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The BANK of NEW YORK

March 23, 2007

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue
Washington, D.C. 20551
**Docket Number R-1261**

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429
**RIN Number 3064-AC73**

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, D. C. 20552
**Number 2006-33**

Office of the Comptroller of the Currency
250 E. Street, SW, Mail Stop 1-5
Washington, D.C. 20219
**Docket Number 06-09**

Ladies and Gentlemen:

The Bank of New York appreciates the opportunity to comment on the Notice of Proposed Rulemaking (NPR) for "Risk-Based Capital Standards: Advanced Capital Adequacy Framework," which, if finalized, would implement Basel II in the United States. Under the proposed rules, the Bank of New York would be classified as a "core" bank and thus required to implement the Advanced Approaches in the United States.

The Bank of New York is committed to implementing Basel II. For the past six years, the Bank has worked with regulators and various industry groups to develop a capital adequacy framework that is more risk sensitive than Basel I and which would incorporate the advanced risk measurement and management techniques practiced by The Bank of New York and other financial institutions. The Bank commends the federal regulatory agencies ("the Agencies") on the release of the NPR; however, there are major areas of concern which we address in this letter. The Bank has divided its comments into two sections: the first section includes comments on overall U.S. implementation of Basel II and the second section includes comments on technical credit risk issues in the NPR. This letter does not include comments on operational risk issues. For operational risk issues, the Bank has contributed to the comment letter to be submitted by the

Advanced Measurement Approaches Group (AMAG), for which the Risk Management Association provides the secretariat.[1]

# I. Overall U.S. Approach to Basel II Implementation

The NPR highlights the Agencies' overall capital objective that "Basel II implementation should not result in a significant decrease in aggregate capital requirements for the U.S. banking system."[2] In Question 11 of the NPR, the Agencies seek comment on what other information should be considered in deciding whether overall capital objectives have been achieved. We believe that the stated objective is contradictory to the spirit of the June 2004 Basel Accord, which is to make regulatory capital requirements more risk-sensitive. The Basel Accord includes as an objective the "broad maintenance of the overall level of risk-based capital requirements while allowing some incentives for banks to adopt the advanced approaches."[3] This objective refers to aggregate capital on an international, not national, level. Since many of the U.S. banks subject to Basel II are already using advanced risk measurement systems and techniques, it follows that these banks would experience significant regulatory capital declines from a risk-sensitive regulatory capital regime.

**Differences between the NPR and the June 2004 Basel Accord**

The NPR includes several provisions which are different from the Basel Accord and which could place U.S. banks at a disadvantage relative to non-U.S. banks. These provisions include the following:

A. *U.S. timetable and transition period*
B. *10% capital benchmark for the entire banking industry*
C. *Maintenance of Tier 1 Leverage Ratio*
D. *Inability to Use Other Approaches, e.g., Standardized Approach*

The Agencies should consider eliminating or revising these requirements to enable U.S. implementation of Basel II to be more consistent with international implementation.

*A. U.S. Timetable and Transition Period*

The U.S. implementation timetable and transition period continue to diverge from that of international jurisdictions. For example, the first available date for parallel running in the United States is currently scheduled for January 2008; the first available date in the European Union was January 2007. Further delay in U.S. implementation would: (1) cause additional uncertainty and increase implementation costs for core banks; (2) create additional home/host issues for U.S. banks implementing Basel II at non-U.S. subsidiaries; (3) place U.S. banks at a competitive disadvantage relative to non-U.S. banks; and (4) affect firms' strategic business plans. We urge

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[1] The Bank of New York has also contributed to comment letters submitted by The Clearinghouse, the American Bankers Association (ABA), and the International Swaps and Derivatives Association (ISDA).
[2] Federal Register, "*Risk-Based Capital Standards: Advanced Capital Adequacy Framework and Market Risk; Proposed Rules and Notices,*" Vol. 71, No. 185, September 2006, page 55839.
[3] Basel Committee on Banking Supervision, *"International Convergence of Capital Measurement and Capital Standards,"* June 2004, paragraph 14, page 4.

the Agencies to address the issues raised by the industry and move to an industry-accepted version of Basel II as soon as possible.

The transitional floor periods, as referenced in Question 10 in the NPR, raise competitive issues and create uncertainty for U.S. banks implementing Basel II. Under the proposed rules, U.S. banks would be subject to higher capital floors during the transition period than non-U.S. banks. In addition, the transition period would be "at least three years" and "a bank's primary Federal supervisor would determine when the bank is ready to move from one transitional floor period to the next."[4] This provision implies that the overall transition period could be more than three years, potentially lengthening the time before banks could fully realize the capital benefits associated with Basel II. The final rules should explicitly define each floor period as one year, with supervisors having the option to extend the period if necessary. We are not aware of any foreign jurisdictions that require a bank's supervisor to approve its transition from one floor period to the next.

*B. 10% capital benchmark for entire banking industry*

To reinforce their stated objective, the Agencies have proposed a reduction of minimum capital requirements of not more than 10% across the industry, as referenced in Question 5 of the NPR. This provision introduces additional uncertainty for core banks. As the U.S. Government Accountability Office's (GAO) report notes, "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."[5] We agree that until these issues are addressed, there is ongoing uncertainty about how Basel II implementation in the U.S. will affect banks' regulatory capital levels.

We also question the statistical basis and rationale for this benchmark. The benchmark appears arbitrary and would penalize all Basel II banks for a fall in the industry's regulatory capital levels. This provision also seems unnecessary given the regulators' ability to require additional capital under Pillar 2.

*C. Maintenance of Tier 1 Leverage Ratio*

The Tier 1 Leverage Ratio, the ratio of Tier 1 Capital to Average Balance Sheet assets, is another provision that places U.S. banks at a disadvantage relative to non-U.S. banks. Since the denominator in the Tier 1 Leverage Ratio is not risk-weighted, for some banks, this ratio will effectively serve as a floor for regulatory capital. Low-risk banks, such as The Bank of New York, would not be able to realize the implied capital reduction from Basel II's risk-sensitive framework since they must comply with the Tier 1 Leverage Ratio. While we acknowledge some of the beneficial aspects of the leverage ratio, such as computability and comparability, the ratio as currently defined also has serious disadvantages. As the GAO report notes, "the leverage ratio could be the higher capital requirement for some banks at some times, especially those with low risk profiles."[6]

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[4] Federal Register, Vol. 71, No. 185, September 2006, page 55843.
[5] U.S. Government Accountability Office (GAO), *"Risk-Based Capital,"* February 2007, page 72.
[6] GAO, page 46.

Maintaining the leverage ratio also provides banks with incentives to maintain risky assets off-balance sheet. If banks must maintain floor capital imposed by the leverage ratio, then they would have an incentive to increase risk to maximize the use of regulatory capital in excess of the level required by their risk-weighted assets but below the capital required by the leverage ratio. This sort of arbitrage is exactly what Basel II was designed to prevent.

The banking industry has considered a sliding, risk-sensitive Tier 1 Leverage Ratio, which the Bank fully supports. Under this approach, low-risk portfolio banks would be permitted to maintain a lower ratio, and higher risk institutions would be required to maintain higher ratios.

*D. Use of the Standardized Approach*

The Bank supports the inclusion of the Standardized Approach in the U.S. implementation of Basel II, as referenced in <u>Question 7</u> of the NPR. Given that the regulatory capital for a given exposure can be materially greater under the Standardized Approach relative to the Advanced Approach, banks will be motivated to progress to the Advanced Approach as soon as possible. (This assumes, however, that the U.S. version of the Advanced Approach allows banks to recognize the capital benefit, i.e., notwithstanding the Tier 1 Leverage Ratio or the 10% industry capital benchmark.) Therefore, if the Standardized Approach were allowed, it should remain available at least until the capital floors imposed under the Advanced Internal Ratings-Based (A-IRB) Approach no longer apply. In that way, assuming no modifications are made to the other approaches, U.S. banks would be in a position to comply with Basel II in line with banks throughout the world.

If a Standardized Approach were allowed for credit risk, the Bank recommends that there be no modifications to the approach outlined in Basel II. Relative to the other approaches, the existing Standardized Approach is a more conservative method of calculating Pillar I regulatory capital. Therefore, there is no need to make the measure of capital more conservative, and although some would argue that there should be less conservatism regarding derivatives, other capital markets transactions, unsettled trades, equity exposures, etc., the potential capital benefits do not justify the time delay and cost of opening up this discussion. The Standardized Approach is well-defined and, because of the less demanding regulatory validation expectations, is already much less expensive to implement than the advanced approach. The regulatory uncertainty and the high cost of implementing the advanced approaches serve to deter banks from committing to additional investment in risk infrastructure. This is especially true given the muted benefits that would result given the Tier 1 Leverage Ratio and the proposed 10% industry capital benchmark.

## <u>A-IRB Qualification Process</u>

Finally, Section 23 (c) of the proposed rule specifies that a core bank must notify the Agency if it fails to meet qualifications requirements after a successful parallel run. The bank is also required to present a remedial plan to the Agency and disclose to the public its compliance failure. The Basel II A-IRB qualification process is an iterative one; banks should not be penalized for failure to qualify. We agree with the comments jointly submitted by the International Swaps and Derivative Association (ISDA), the Institute for International Finance (IIF), and the London Investment Banking Association (LIBA) regarding this issue. Banks should not be required to report publicly Basel II qualification failures. Such disclosure would only serve as a disincentive for other banks to "opt-in" to the Basel II regime.

We are also concerned that this rule could be implemented differently across core and opt-in banks which have different federal regulators. In addition, there appears to be no continuum between qualification and failure. As a result, bank examiners may come under undue pressure to "pass" a marginal core or opt-in bank.

**Mergers and Acquisitions**

As referenced in Question 20 of the NPR, the proposed rules regarding mergers and acquisitions are not sufficiently clear for core banks with merger or acquisition activity. The proposed rules specify that:

> if a bank merges with or acquires a company that does not calculate its risk-based capital requirements using advanced systems, the bank may use the general risk-based capital rules to determine the risk-weighted asset amounts for, and deductions from capital associated with, the merged or acquired company's exposures for up to 24 months after the calendar quarter during which the merger or acquisition consummates.[7]

It is not specified whether banks that merge with or acquire another bank prior to the effective date of the proposed rules could take advantage of this provision. For banks that would rely on this provision, several questions are left unanswered by the proposed rules. For example, should a core bank that merges with or acquires a bank not using the advanced approaches conduct a parallel run separate from that of the merged or acquired company? Are core banks expected to conduct a parallel run on the acquired or merged company's exposures prior to taking advantage of any capital relief allowed during the transitional floor periods?

To eliminate the ambiguity caused by the 24-month rule described in Section 23 (b) of the proposed rules, the Agencies should consider allowing a "phased implementation approach." Under a phased approach, banks would be allowed to implement Basel II for various business lines and/or portfolios over a specified time period. Both the June 2004 Basel Accord and the European Union's Capital Requirements Directive (CRD) include such a phased approach. The CRD specifies that Basel II implementation under the A-IRB approach "shall be carried out under strict conditions determined by the competent authorities."[8] As a result, in the United Kingdom, for example, the exposures in the implementation/roll-out plan are agreed to by the supervisor during the IRB qualification process. We also understand that roll-out plans in the UK generally adhere to the following guidelines:

- The roll-out period is approximately three years but may be re-negotiated if a merger or acquisition occurs during the roll-out period[9]
- Each portfolio in the roll-out plan should parallel run for at least one year[10]

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[7] Federal Register, Vol. 71, No. 185, September 2006, page 55925.
[8] European Parliament and the Council of the European Union, *"Capital Requirements Directive,"* October 2005, Article 85, paragraphs 1 and 2.
[9] UK Financial Services Authority, "*BIPRU 4: The IRB Approach*," paragraphs 4.2.21, 4.2.35.
[10] www.fsa.gov.uk/pages/Library/Other_publications/EU/other_documentation/general/parallel

The inclusion of a phased approach as described above would allow core banks, such as The Bank of New York, flexibility to capture the merged or acquired company's exposures while not jeopardizing the core bank's ongoing implementation efforts, e.g., parallel run, transitional floor periods, etc. For the past six years, The Bank of New York has been committed to implementing Basel II at the earliest possible date. Under the current proposal, if a merger were to occur prior to the effective date of the final rules, the Bank would be forced to delay its implementation efforts. Such a delay would be extremely costly as critical system development projects would be placed on hold, then re-started once the merged entities are fully integrated. Given the already high costs associated with Basel II implementation, we urge the Agencies to allow firms with merger activity to implement on a phased basis, beginning at the earliest possible date.

**Pillar III**

Industry participants and regulators have focused on Pillar I, but the importance of Pillar III should not be underestimated. Neither the regulators nor the industry have adequately studied the usability, feasibility, or appropriateness of these disclosures. Since market discipline is its goal, Pillar III disclosures should be rolled out carefully to allow accurate and effective interpretation by market participants.

The final rules should provide clear and practical examples of Pillar III minimum reporting requirements without requiring material information which could create competitive disadvantages. The current form of Pillar III reporting is too granular in places. In particular, the credit loss history and securitization disclosures are too detailed. Market participants, including competitors, could gain an unnecessarily detailed picture of a bank's credit portfolio over time. In addition, the "market discipline" function could grow too strong; instead of monitoring bank credit policy, the market could potentially unduly influence bank credit policy.

Market and competitive forces may eventually force convergence to a Pillar III standard, but at a substantial and unwarranted cost. Delivery of simpler and structured reporting requirements would lower the learning curve for Pillar III public users, resulting in maximum Pillar III usability and the market discipline Pillar III was designed to impose.

## II. Technical Credit Risk Issues

### *A. Definition of Default*

The definition of default referenced in Question 14 of the NPR differs from that included in the Basel Accord and the Advance Notice of Proposed Rule-making (ANPR). The Bank recommends that the Agencies use the default definition included in the June 2004 Accord. In the June 2004 Accord, a default is considered to have occurred when an obligor is 90 days past due on any material credit obligation or when an obligor is considered "unlikely to pay." The Basel Accord notes that "unlikely to pay" could include any of the following scenarios:

- Borrower is placed in non-accrual status

- Exposure is charged-off
- Exposure is sold at a material credit-related economic loss
- Distressed restructuring of the exposure
- Borrower has filed for bankruptcy[11]

The definition of default is the foundation for a bank's internal ratings-based system. Once a bank has determined that an obligor is in default, this classification will necessarily affect the bank's Probability of Default (PD), Loss Given Default (LGD) and Exposure at Default (EAD) parameters. Any material change to this definition will render irrelevant any statistics gathered on the basis of the previous definition. The IRB definition of default should be consistent with other default definitions and this definition must remain consistent over time.

The definition of default under the current proposal is not aligned with the Basel Accord in several respects. However, one difference is especially critical--that an obligor be placed in default if the Bank experiences a credit-related loss of five percent or more on the sale of any exposure to the obligor. The final rules should not include this criterion. While the Bank understands supervisors' concerns regarding asset sales, marking borrowers as defaulted based on the sale of an exposure is problematic. First, external default definitions do not include the 5% criterion. Including this criterion would cause a mismatch with external data sources such as Moody's and S&P Ratings, S&P's LossStats database, etc. Data collected using the 5% definition may be commingled with data collected not using this definition, causing complications when estimating any default-driven statistics.

Second, this definition would arbitrarily distort the definition of PD and LGD on a bank-by-bank basis, based on the bank's distressed asset disposition policy. Further, the 5% rule would cause a bank that changes its disposition policy to invalidate all of its internal default statistics.

Third, the 5% threshold may limit banks' flexibility regarding asset sales. There may be cases when a credit exposure may be technically distressed, but the Bank expects the asset to be serviced in full. There are other cases when the counterparty is not distressed at all, but for strategic reasons (concentration risk, overall portfolio balancing, mergers & acquisitions, etc), the bank may choose to sell the assets at a discount. Banks should be allowed to transfer assets in a manner consistent with their overall risk profile. If asset sales at a discount are a concern, regulators could require disclosure rather than including these sales in the definition of default.

Finally, the Bank considers objective validation to external wholesale default databases incompatible with the 5% rule. The Bank will keep statistics as required, but will validate default parameters to senior management excluding 5% sale events.

*B. Estimating Downturn LGDs*

The Basel Committee and the Agencies have spent considerable time and energy discussing issues related to estimating and using downturn LGDs, as referenced in Question 16 of the NPR. Unfortunately, to date, the discussions of this issue have focused on the technical aspects of

[11] Basel Accord, June 2004, paragraphs 452-453.

measurement rather than the applicability and appropriateness of the concept itself. There is real danger in continuing the technical discussion without carefully considering the viability of downturn LGDs, portfolio by portfolio.

The precision of the downturn LGD language in paragraph 468 of the June 2004 Basel Accord is appropriate, given the definitional and measurement difficulties inherent in estimating the parameter. For instance, the Bank of New York agrees that economic downturns are an appropriate consideration in estimating the LGD parameter for retail real estate lending. Even so, we do not have hard data on these exposures over the last dozen years to estimate downturn LGDs. We would, and we plan to, make an appropriate subjective adjustment that reflects a perceived LGD dependence on real estate valuation trends. On the other hand, estimating meaningful downturn LGDs for our wholesale portfolios is insupportable from the data.

The definition of stress in downturn LGDs needs focused attention. The current proposal mandates across-the-board recognition of downturn LGDs, generating an across-the-board “stress component” to Tier I Capital. Across-the-board stress increments require an across-the-board definition of stress scenario. From our experience, we can point to stress in telecommunications, airlines, Real Estate Investment Trusts (REITs), internet startups, Latin American sovereign defaults and Korean chaebol difficulties, but we have never seen them occurring all at once. In fact, the whole point of correlated portfolio capital models is to extrapolate to such an unobserved stress.

As a low-default portfolio bank, we have very limited internal default history to estimate loss given default for our wholesale portfolio. To put it bluntly, we are hard pressed to support estimated LGDs even for large segments of the wholesale portfolio from actual experience. Externally available investment-grade default data do not support fine-grained statistical analysis. However elegant the theory, data must be respected. The data on wholesale LGDs suggest maintaining the status quo on paragraph 468, which means a thoughtful, subjective LGD adjustment in selected situations, without hard data support. It is for good reason that wholesale downturn LGDs generally fail the use test. We urge the Agencies not to mandate a regulatory superstructure that the data simply do not support.

*C. Consideration of collateral in borrower rating*

In the current proposal, the Agencies are proposing to eliminate the specialized lending category with the exception of high volatility commercial real estate (HVCRE). In addition, the proposed rule specifies that “a bank may not consider the value of collateral pledged to support a particular wholesale exposure 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.”[12]

However, the ANPR makes specific reference to a “specialized lending” category:

> A defining characteristic of SL exposures (including CRE) is that the risk factors influencing actual default rates are likely to influence LGDs as well. This is because *both* the

[12] Federal Register, Vol. 71, No. 185, September 2006, page 55845.

> borrower's ability to repay an exposure *and* the banking organization's recovery on an exposure in the event of default are likely to depend on the same underlying factors, such as the net cash flows of the property being financed. This suggests a positive correlation between observed default frequencies and observed loss rates on defaulted loans, with both declining during periods of favorable economic conditions and both increasing during unfavorable economic periods. While cyclicality in LGDs may be significant for a number of lending activities, the Agencies believe that cyclicality is likely to be the norm for SL portfolios, and that a banking organization's procedures for estimating LGD inputs for SL exposures should assess and quantify this cyclicality in a comprehensive and systematic fashion.[13]

We agree with the ANPR on this issue. Collateral can support the borrower rating if the risk is not based on the borrower, but rather solely on the value of the underlying assets (such as real estate). If the collateral declines in value, it directly affects the borrower's probability of default. For asset-based exposures, PD and LGD both depend on the value and volatility of the underlying assets, and collateral needs to be taken into consideration. Philosophically, the Bank understands the rationale of separating the PD from the LGD, but practically speaking, how should the Bank separate the two in cases where there is a strong correlation? How should the Bank take into consideration the cash flows of the borrower without taking into consideration the value of the collateral?

*D. Exclusion of certain financial collateral*

All financial instruments should be eligible for consideration as financial collateral as referenced in Question 34 of the NPR. The proposed rules limit financial collateral to: "cash on deposit with the bank (including cash held for the bank by a third-party custodian or trustee); gold bullion; long-term debt securities that have an applicable external rating of one category below investment grade or higher; or short-term debt instruments that have an applicable external rating of at least investment grade." [14]

Non-investment grade collateral has a valid place in risk-mitigation, especially when part of a large pool of collateral where its explicit exclusion would be both costly and disruptive. If the final rules disallow the value of sub-investment grade securities collateral in EAD calculations, the resulting calculation would add significant expense to the collateral valuation process, while in our case, distorting the financing of broker-dealer inventories, indemnified margin lending, and other rigorously margined secured lending arrangements. Where sub-investment grade collateral is permissible under the terms of the lending contract, the rule would create a material, needless divergence between Basel exposure and economic exposure.

This issue is absolutely critical for banks with a significant portfolio of repo-style transactions. To help determine the EAD for these exposures, the Bank of New York has built an engine which estimates the regulatory Value at Risk (VaR) for hundreds of counterparties. This process is extremely data intensive; the Bank processes approximately one million positions daily. If the Bank were required to exclude sub-investment grade securities from this calculation, the VaR estimation and processing costs for this portfolio would increase dramatically. A similar issue

[13] Federal Register, *"Risk-Based Capital Guidelines; Implementation of the New Basel Accord,"* Vol. 68, No. 149, August 2003, pages 45914-45915.
[14] Federal Register, Vol. 71, No. 185, September 2006, page 55869.

arises if a security is unrated; the Bank would need to identify and exclude these securities. This additional layer of processing would increase costs dramatically. In the context of actively margined lending, categorical exclusion of non-investment grade debt securities has no risk-based rationale. One need only consider that all the equity securities of these sub-investment grade issuers are eligible collateral under the NPR. Moreover, the secondary damage of disrupting the financing of broker-dealer inventories would appear inevitable under the proposed rule.

*E. Materiality and Proportionality*

The final rules should define a materiality threshold**.** In Section 21 (b) (2), the Agencies note that banks must "justify and support any proposed temporary or permanent exclusion of business lines, portfolios, or exposures from application of the advanced approaches in this appendix (which business lines, portfolios, and exposures must be in the aggregate, immaterial to the bank)."[15] Although mentioned several times in the proposed rules, "immaterial" is never explicitly defined.[16] While there should be rigorous analyses, including stress testing, in confirming the assumption that a portfolio is immaterial, the overall size of a portfolio should be considered as an indicator of materiality.

In addition to defining materiality, we urge the Agencies to adhere to the "proportionality" principle, especially regarding ratings validation. Banks must carefully allocate limited resources between technology, process, and validation. Supervisors should review validation processes with respect to the nature, size, scale, and complexity of the institution or line of business. For example, validation requirements for private banking exposures should not be the same for a bank in which private banking represents 30% of its exposure versus another bank where private banking represents 5% of its exposure. Where the Bank of New York has very small exposure, we will proportionately adjust our validation effort. Where a model or quantification assumption (versus a portfolio) is deemed immaterial, the validation requirement should also be in proportion to its likely impact on the bank's overall exposure or capital. The Bank notes that European regulators have explicitly encouraged the use of proportionality when reviewing an institution's validation program.[17]

## III. Conclusion

The Bank of New York is committed to implementing Basel II. We have dedicated significant resources to developing systems and processes. To lay the foundation for Basel II qualification, we have participated in several regulatory discovery reviews. We also have worked with the industry and with regulators to help develop a regulatory capital regime that is prudent and reflects industry best practice.

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[15] Federal Register, Vol. 71, No. 185, September 2006, page 55922.

[16] The proposed rules define materiality for regulatory reporting purposes only.

[17] Committee of European Banking Supervisors (CEBS), *"Guidelines on the Implementation, Validation and Assessment of Advanced Measurement (AMA) and Internal Ratings- Based (IRB) Approaches,"* January 2006, page 10.

The final U.S. Basel II rules should be consistent with the June 2004 Basel Accord. By definition, many core banks are internationally active and in most cases, are implementing Basel II in one or more international jurisdictions. Major differences between U.S. and international Basel II implementation would create disparities, increase implementation costs, and raise difficult home/host issues. We urge the agencies to limit the areas in which the final rules diverge from the June 2004 Accord.

The final rules should not include provisions that are not based on empirical studies or do not reflect consensus among international regulators. The final guidance should also strike the appropriate balance between incorporating conservatism and providing reasonable incentives for banks to adopt the Advanced Approaches. Certain provisions, including the 10% capital benchmark, the IRB definition of default, and the across-the-board requirement to estimate downturn LGD, are not empirically-based. Other provisions, such as the transitional floor periods and the maintenance of the Tier 1 Leverage Ratio, would place U.S. banks at a disadvantage relative to non-U.S. banks implementing Basel II.

U.S. banks implementing Basel II also need more clarity regarding mergers and acquisitions. Given strong competition in the financial services industry, merger activity among core or opt-in banks will only increase in the future. As a result, these banks will need significantly more guidance about the effects such activity would have on regulatory capital requirements. Merger activity should not negatively affect banks implementing Basel II. Banks should be allowed to "phase-in" the additional business lines or portfolios over time. The rules regarding this process should be practical and transparent.

Again, the Bank of New York is committed to implementing Basel II. If regulators insist, however, on removing all aspects of risk-sensitivity from the U.S. version of Basel II, the muted benefits of implementation simply do not justify the costs. We urge the Agencies to address the issues raised by the industry and move to an industry-accepted standard. To that end, we look forward to the issuance of the final rules for U.S. implementation. The Bank of New York will continue to work with the industry and with regulators to develop a Basel II rule that is pragmatic and consistent with the rules in other jurisdictions.

Sincerely,

/Signed/

Thomas P. Gibbons