Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552
Re: No. 2006-33

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

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Re: Docket No. R-1261

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, DC 20219
Re: Docket Number 06-09

Re: Comment on Basel II Joint Notice of Proposed Rulemaking

Dear Ladies and Gentlemen:

ING Bank, fsb (ING DIRECT) appreciates the opportunity to comment on the Basel II notice of proposed rulemaking (NPR).

ING DIRECT respectfully recommends that the Agencies:

- Align the NPR with the international Basel II Accord (Accord) and the European Capital Requirements Directive (CRD)
- Remove or lower the risk-insensitive Leverage Ratio
- Finalize the NPR and proceed with implementation without further delay

ING DIRECT, with approximately $66 billion in assets, provides retail banking services and financial products to individuals and businesses across the United States. Because its ultimate parent, ING Group, based in The Netherlands, is subject to Basel II standards in the European Union, ING DIRECT is required to undertake many of the analyses required by Basel II in order to enable its parent to comply with standards made applicable in the EU. ING DIRECT therefore finds itself in a unique situation to comment on the NPR. While ING DIRECT is not a "Core Bank" under the NPR, ING DIRECT must comply with capital standards applicable in the U.S., including adopting Basel IA or opting-in under Basel II. This comment letter is informed by our obligation to comply with these differing standards.

ING DIRECT supports the Basel II objectives of enhancing the risk sensitivity of the regulatory capital framework and encouraging the development of sound risk measurement and management practices. The Agencies are missing a crucial opportunity, however, to put the U.S. banking system on par with its international counterparts. As detailed later in this letter, the disparity between the NPR and the Accord and CRD will create a competitive advantage for foreign banks.

ING DIRECT urges that the Agencies more closely align the NPR with the Accord and give U.S. banks the option to use the same approaches that are available to banks outside of the U.S. By allowing these approaches, the NPR would put U.S. banks on a level playing field with banks in other countries, while the risk sensitivity of credit risk could be improved.

Despite generally supporting the proposed rule, ING DIRECT strongly opposes the retention of the leverage capital requirement. The proposed leverage capital requirement results in an excessive capital charge against low risk assets such as mortgages and investment securities. If the current NPR is left in its present form, there will be significant unintended consequences. The risk insensitivity of the Leverage Ratio poses a moral hazard, particularly for institutions that have sizeable exposures in low risk assets like residential mortgages. These institutions will be encouraged to seek out higher risk assets to earn higher returns to counter the effects of the risk insensitive leverage ratio. As the OTS Director John Reich noted in his testimony before the Committee on Banking, Housing and Urban Affairs, "a risk-insensitive leverage ratio works against a financial institution's investment in low-risk assets" and "such a system may perversely motivate low credit risk lenders to pursue riskier lending"[1]. The retention of a leverage capital ratio that is not adjusted for credit risks, interest rate risks, liquidity risks or operational risks works directly contrary to the goal of the Basel process of enhancing the risk sensitivity of the regulatory capital framework.

The NPR is also exceptionally damaging for U.S. banking organizations that are subsidiaries of foreign banks. Compared to banks operating under the Accord (or CRD), U.S. operations will be required to hold more capital than its foreign counterparts to conduct the same type of banking activities. Parent companies of international banks will be spurred to withdraw capital from the U.S. market and redeploy capital into foreign markets that are less capital intensive. This will impact not only foreign-owned banking organizations, but also U.S. owned banking organization as investors generally will be encouraged to move their investments to foreign banking organizations, as those organizations will be able to more efficiently allocate capital in order to earn a better return.

Not only does the disparity between the U.S. NPR and the Accord create a competitive advantage for foreign banks, but also for non-bank mortgage lenders. Mortgage lenders who are not required to hold capital based on the Leverage Ratio may out perform

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[1] Statement of John M. Reich, Office of Thrift Supervision, concerning the "Development of a New Basel Capital Framework" before the Committee on Banking Housing and Urban Affairs, United States Senate November 10, 2005.

regulated banking organizations by simply offering a lower price to customers. The leverage ratio puts U.S. banks whose primary business is the issuance of residential mortgages at a competitive disadvantage by keeping their costs higher than a true risk analysis requires. Significant public policy reasons support adopting rules that encourage the origination of mortgages in insured institutions. The active supervisory oversight given by banking agencies tends to deter predatory and abusive lending practices. Community Reinvestment Act incentives to reach out to low and moderate income borrowers also apply only to insured institutions. To prevent a flight of the mortgage origination business away from regulated institutions, we strongly encourage the Agencies to eliminate the risk-insensitive Leverage Ratio for financial institutions or at least significantly lower this ratio for savings organizations that have significant residential mortgage exposures.

In a recent study on Basel II, the U.S. Government Accountability Office (GAO) stated that any further delay in the U.S. implementation of Basel II would create a potential competitive disadvantage for U.S. banks when compared with foreign banks. ING DIRECT shares the GAO's view that further delay will add to uncertainty and create burdens for both domestic and foreign banks. U.S. banks are already one year behind the European schedule. ING DIRECT urges the Agencies to complete their efforts to finalize the U.S. Basel II capital rule immediately.

Below we provide more specific comments and questions based on our understanding of the Basel II NPR proposal.

Specific Basel II NPR Proposals

1. **(Question 6) The agencies seek comment on all potential competitive aspects of this proposal and on any specific aspects of the proposal that might raise competitive concerns for any bank or group of banks.**

The NPR raises competitive concerns for U.S. banks in the following areas:

- The risk-insensitive Leverage Ratio for U.S. banks (as discussed above)
- The deviation from the Accord in the definition of default and Loss Given Defaults (LGD) (as discussed in response to questions 14 and 16 below)
- The extension of the transitional periods with higher capital floor requirements
- A 10 percent or greater decline in aggregate minimum required risk-based capital

The transitional period is too long. The NPR proposes a three year transition period, with a five percent decline in capital permitted for each of the transition periods; while the Accord only imposes a two year transition period, with a ten percent decline in capital permitted for each period. In addition, U.S. banks would be required to receive approval from the Agencies to move from one transition period to another. We urge the Agencies to align the NPR transitional periods, and applicable capital restrictions, with the Accord. Any concerns over capital levels should be addressed by the Agencies through the Pillar 2 process under the NPR.

The NPR treats a 10 percent decline in aggregate minimum required risk-based capital as a material reduction, resulting in possible modifications to the capital framework. In contrast, the Accord does not impose this restriction. This means that foreign banks may be required to hold significantly less capital, freeing that capital up for other investment and giving those banks a significant competitive advantage. By imposing this artificial limitation on U.S. banks, this proposal defeats the premise of the Basel II framework to "maintain sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks.... [and to] preserve the benefits of a framework that can be applied as uniformly as possible at the national level."[1]

2. **(Question 14) The agencies seek commenters' views on specific issues raised by applying different definitions of default in multiple national jurisdictions and on ways to minimize potential regulatory burden, including use of the definition of default in the New Accord, keeping in mind that national bank supervisory authorities must adopt default definitions that are appropriate in light of national banking practices and conditions.**

ING DIRECT strongly recommends that the Agencies restore the **"non-accrual status"** criterion to the retail definition of default in the final rule. That criterion had been contained in the October 2004 proposed Supervisory Guidance for Advanced Internal-Ratings Based Approach (AIRB).

The Agencies amended the definition of default for retail exposures in the NPR, assertedly to bring the definition in line with the Federal Financial Institutions Examination Council's (FFIEC) Uniform Retail Credit Classification and Account Management Policy. The Agencies considered that retail non-accrual practices varied considerably among banks and concluded that removing non-accrual from the retail definition of default would promote greater consistency among banks. The NPR now defines default for revolving retail credit and residential mortgages as 180 days past due. Other retail exposures would be in default after 120 days past due. This change not only penalizes conservative bank management, but also decreases consistency between U.S. and foreign banks.

Under the FFIEC guidelines any retail credit that is 90 days past due is classified as substandard. The instructions in the Thrift Financial Report require an institution to place assets in non-accrual status if the bank does not expect to receive full payment of interest or principal, or when the principal or interest is in default unless full collection against collateral is probable. Clearly, a bank can reasonably treat any substandard loan as one on which the bank does not expect to receive full payment, and can place the loan on non-accrual. Requiring banks to adopt the approach of classifying a loan as being in "default" after the loan is in 120 or 180 days past due status would penalize what would otherwise be viewed as a conservative approach, such as applying 90 days past due to determine the default.

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

While many banks wait as long as allowed by the FFIEC Guidelines to classify a loan as "loss," the FFIEC Guidelines allow a bank to do so in advance of 120 days if the bank chooses. The FFIEC Policy states: "This policy does not preclude an institution from adopting a more conservative internal policy." Forcing banks to postpone treating loans as in default until the last deadline permitted under the FFIEC Guidelines is directly contrary to the Basel II purpose of improving sound risk management.

This change to the definition of default also creates a discrepancy between the international Accord and the NPR. The Accord and CRD treat loans that are 90 days past due as being in default. ING DIRECT must treat loans that are 90 days past due as in default for purposes of the reporting made by its parent. If ING DIRECT must now treat loans as not being in default for U.S. capital purposes until 120 or 180 days past due, it will need to create and maintain two parallel systems for tracking its loans and for projecting defaults. We recognize the Agencies may not want to mandate that all U.S. banks must adopt a 90 day default rule. But a little flexibility, such as reinstating the ability of banks to treat loans in default if placed in non-accrual, would enable ING DIRECT to have a single system for reporting to both jurisdictions. ING DIRECT customarily places residential mortgages on a non-accrual status when they become 90 days past due.

The divergences in the definition of default have implications not only for tracking but also for rating validation, reporting of risk-weighted asset calculations, and the use test. The discrepancy between the two definitions of default could create an undue burden for international banks operating in the U.S. to maintain two Probabilities of Default (PD), and the two resulting capital calculations. Because of that, these banks not only need to develop and validate different PD models based on different default definitions, but also need to maintain two costly capital reporting systems to comply with both U.S. and foreign capital rules. Even more difficult is the reconcilement and the comparison of these two capital measures. To harmonize the NPR with the Accord and avoid unnecessary dual capital systems, ING DIRECT strongly urges that the "non-accrual status" criterion should be retained in the retail definition of default in order to allow greater consistency between the NPR and Accord in the treatment of retail exposures.

In addition, ING DIRECT is concerned over the definition of default for wholesale exposures. Under the NPR, a wholesale obligor is in default if the banking institution has incurred a credit-related loss of 5% or more of a wholesale exposure's initial carrying value in connection with the sale of the exposure. There are instances, however, where a 5% credit loss should not constitute default. For example, a position could decline 5% temporarily due to credit problem speculations in the market, such as speculation or rumors of bankruptcy, but where it could also recover shortly after. Because of this rule, banks could be forced to classify such exposures as being in default. A temporary decline that may recover quickly should not be treated as a default. ING DIRECT notes that there is no similar requirement under the Accord and the CRD. To avoid further divergence, ING DIRECT urges the Agencies to use the Accord's definition of default for wholesale exposures.

3. (Question 16) The agencies sought comment on and supporting empirical analysis of (i) the proposed rule's definitions of LGD and ELGD

ING DIRECT proposes that the LGD (Loss Given Default) requirements under the NPR converge with those of the Basel II Accord and CRD to prevent any competitiveness concerns and avoid undue reporting and compliance burdens for U.S. banks.

Under the NPR, the proposed LGD provisions require the bank to calculate two LGDs: one based on average economic loss (ELGD) and another during economic downturn (LGD). These multiple LGDs not only deviate from the international Accord's single LGD standard but also cause inconsistencies between the Expected Loss (EL) and minimum risk-based capital measures in the Accord and NPR.

This discrepancy in the definition of LGDs has implications for loan loss provisions, reporting of risk-weighted asset calculations and the use test, particularly for international banks. For example, under the NPR, the ELGD is used for the EL calculation and the LGD is used in the capital calculation. In contrast, only LGD is used for both EL and capital calculation under the Accord (and CRD). This difference would cause internationally owned banks operating in the U.S. to have two different ELs and Risk-Based Capital ratios, one under the NPR and one under the Accord. It is incongruous that the amount of capital mandated is different under the NPR or the Accord (and CRD) when the underlying risk remains the same, creating an unnecessary and unwarranted burden. In addition, the maintenance of multiple LGD measures would increase unnecessary reporting and compliance burdens for internationally owned U.S. banks as well as creating a competitive advantage for foreign banks.

ING DIRECT is also concerned about the supervisory mapping function for the downturn LGD calculation (LGD = 8% + 92% * ELGD). This prescribed supervisory mapping function does not take the underlying collateral into consideration and, in opposition to the goals of the NPR, it is not risk sensitive. The result of the imposed 8% floor is to penalize high credit quality assets with very low losses and assign a punitive higher regulatory capital charge to these credit assets even at the time of an economic downturn. For example, Repos which are collateralized by U.S. treasury securities, with virtually no credit risk (i.e., an ELGD of 0%), would be assigned an 8% LGD floor. This is clearly an excessive capital requirement. While ING DIRECT appreciates the Agencies' effort to provide a solution to banks who are not able to determine the downturn LGD, this supervisory mapping formula for LGD would result in a higher regulatory capital charge and cause a competitive disadvantage for U.S. banks that operate in a financially conservative manner. We suggest that the Agencies adopt the European Union approach which permits institutions to build into LGD a "margin of conservatism" when there is no economic downturn data available. The margin of conservatism used ordinarily by foreign banks would be substantially less than 8%.

4. **(Question 30) The agencies seek comment on wholesale and retail exposure types for which banks are not able to calculate PD, ELGD, and LGD and on what an appropriate risk-based capital treatment for such exposures might be.**

ING DIRECT proposes that the Agencies take a flexible approach to allow banks to apply alternative approaches other than AIRB to treat certain types of immaterial retail and wholesale exposures. Banks should be given the flexibility of choosing a suitable risk-based capital calculation approach based on their own situations. For example, once a bank adopts the AIRB, the AIRB should only apply to material portfolios. Immaterial portfolios should not be subject to the AIRB requirement. Excluding immaterial portfolios from the AIRB requirement would limit any unnecessary financial and operational burden and regulatory oversight. The method of assessing capital adequacy should be appropriate to the size and complexity of each bank's balance sheet and business model. Banks should be given the option of choosing between Basel IA and the Standardized Approach when calculating capital for immaterial portfolios.

5. **(Question 4) The agencies sought comment on the use of a segment-based approach rather than an exposure-by-exposure approach for retail exposures.**

ING DIRECT believes that the Agencies should not prescribe how banks segment retail exposures. A bank should be allowed to make its own choice to determine the appropriate segmentation approach for the retail exposure based on its own situation. For example, a bank may already have segments defined based on its own internal rating scales. To map the already defined segments to regulatory prescribed reporting segments creates an undue burden and cost to banks. If, however, banks are permitted to use internally-defined segments, they will not only be enabled to manage the credit risk in the same way they actually segment the exposures but also will allow those banks to better define customer/loan segments. ING DIRECT proposes that banks be allowed to use internally-defined segments, rather than aggregating segments in the supervisory reporting bands.

6. **Concerns on the definition of Exposure at Default**

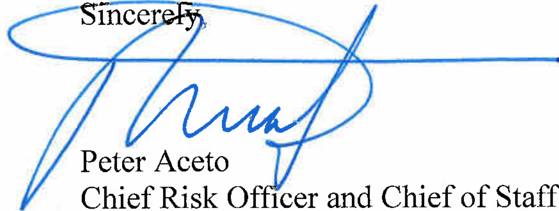
Exposure at Default (EAD) is not prescribed in either the Accord or the CRD; however, the NPR requires banks to estimate net additions to exposures to determine the EAD. As a result, U.S. banks would have to collect fee information – which they are not required to do under the Accord. ING DIRECT believes that fees should not be included in the estimation of EAD and estimating these fees will result in an unnecessary burden to U.S. banks.

Summary of Conclusions

ING DIRECT supports the prompt implementation of Basel II, but remains concerned over the inconsistencies between the Accord, CRD and the NPR. Specifically, we urge the Agencies to consider the elimination of the Leverage Capital Ratio – or in the alternative to at least lower the ratio - and we suggest using Pillar 2 to remedy any capital concerns. We also recommend aligning the NPR and the Accord to eliminate competitive advantages for foreign banks. The alignment of capital regimes would also help foreign banks operating in the U.S. avoid the very difficult and costly burden of maintaining incongruent regulatory reporting systems. It is vital that the disparate treatment of U.S. and foreign banks is not further aggravated by delay. The Agencies should finalize the rule immediately and allow affected U.S. banks to begin the process of implementation, even though we recognize that the Agencies may need to make further changes in the rule even during the implementation phase.

We again thank the Agencies for their effort to refine the current regulatory capital framework and resolve the potential competitive inequality as a result of Basel II implementation. If you should have any questions regarding this letter, please feel free to contact me at (302) 255-3888.

Sincerely,



Peter Aceto
Chief Risk Officer and Chief of Staff
ING Bank, fsb