European
Banking
Federation
Secretary General

Ref.: 0256

H7001FEH
UW
March 2007

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Subject: **Joint Notice of Proposed Rulemaking of the US Banking Supervisors on Risk-Based Capital Standards: Advanced Capital Adequacy Framework - OCC Docket Number 06-09; Board Docket No. R-1261; FDIC RIN 3064-AC73; OTS No. 2006-33/ RIN 1550 – AB 56**

Ladies and Gentlemen,

The European Banking Federation (EBF) is the umbrella federation of 29 national European banking federations. It represents the interests of over 5000 European banks, large and small, with assets of more than EUR 20 000 billion and over 2.3 million employees.

Whilst we recognise that the proposals made in the US for the implementation of the Basel II capital standards concern in the first place the domestic business, we nevertheless take the liberty to submit some general comments in consideration of the fact that Basel II has been designed as an International Accord. Against this background we address the issue in the first place from the broader angle of the overarching aim of global supervisory consistency and convergence as one of the core intentions of the Accord. We have therefore chosen not to go into detailed technical considerations, but would nonetheless like to mention a number of issues where we expect banks to encounter particular consolidation difficulties. We would also emphasise that, whilst the gap period will pose many practical problems and will provide opportunities for regulatory arbitrage, consistency of the final rules should be given priority over the timing.

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On a general note we welcome the progress made in the US for the implementation of the Basel II rules for large, internationally active institutions. We equally welcome the intentions of enhancing the risk-sensitivity of the capital adequacy rules for smaller institutions. However, we are concerned that the overall approach adopted in the US risks to diverge significantly from the one adopted in the other Basel Committee countries in terms of both substance and timing. The European banking industry continues to believe that the current set-up of the Basel II rules is appropriate, and we would object to any changes being made at this stage to the Accord or to its implementation in Europe. We also urge the undersigned of the Accord, as well as the political forces in the US and in Europe to give renewed support to this common project, including the objectives of increasing supervisory cooperation and convergence and those of enhanced risk-sensitivity and reward of good risk management practices.

At the same time we recognise that there is also a need for pragmatic solutions for the immediate practical problems arising from notably the timing gap in Basel II implementation in Europe and the USA. For the interim period, we respectfully suggest that the mutual recognition of the rules applied in the EU on the one hand and in the US on the other hand should prevail. This approach will avoid costly and unnecessary duplication of work and contribute to supervisory cooperation and convergence.

For a number of cases, mutual recognition should in our view also be part of the longer-term solution to deal with the divergences of the EU and US approaches to Basel II implementation. In this context, we would like to mention the areas where we expect the divergences between the rules applied in the EU and those currently under consideration in the US to be most significant. These concern in particular the metrics of the Accord, i.e. the definition of default and the definition and floors of the risk parameter Loss Given Default (LGD). Furthermore, we believe that there are difficulties related to the proposed scope of application of the rules, both as regards the mandatory status and the scope of the exemption applied for banks that fulfil the well-managed and well-capitalised requirements as laid down in the Federal Reserve letter SR 01-01. These aspects are set out in our specific remarks below.

Specific remarks

Architecture of the Basel II NPR

- *Scope of application*

We acknowledge that there is a divergence in the **scope of application** chosen by the US and by other jurisdictions, and that Basel II will in the US only apply to a limited number of institutions. We welcome however the US' decision to seek to improve the risk management of also smaller and medium-sized institutions through the Basel 1A rules. We would alternatively, and indeed preferably, welcome the introduction of the standardised approach in the US, as it has been considered in the recent discussion.

In general, we continue to believe that the regulators' and the industry's ultimate goal should be that at least the large, internationally active institutions adopt the genuinely risk-sensitive advanced approaches for the most significant share of their portfolios. In line with the original spirit of Basel II, this should in our view go along with the reward of good risk management practices through an adequate capital relief. However, we would also see merit in giving banks the opportunity to implement simpler approaches for a limited part of their portfolio in case that the implementation of the advanced approaches would be too burdensome or for other reasons not possible for some of their subsidiaries.

- *Mandatory status*

As it currently stands, the definition of core banks would give rise to a number of difficulties for foreign-based organisations, especially as regards the application of the threshold and the scope of the exemption for well-managed and well-capitalised institutions, pursuant to the Federal Reserve letter SR 01-01.

The agencies suggest that a deposit institution (DI) be considered a core bank if it holds consolidated assets of $250 billion or more, or if its consolidated total on-balance sheet foreign exposure exceeds $10 billion, disregarding whether or not these assets are attributable to DI subsidiaries. As a result of this requirement, FBOs might have to adopt the advanced Basel II approaches for a comparatively small DI representation. As these institutions already have such a sophisticated system in place on the consolidated level, this would not add any management value and would therefore not justify the necessary investment. Furthermore, a separate global model would in many cases not be feasible due to a lack of data, especially for operational risk. In addition, contradictions in the use test would be unavoidable as it is logically only possible for an institution to comply with the use test for one global model, but not with two or more.

In addition to this, we would appreciate explicit clarification on the provision that "a DI also is a core bank if it is a subsidiary of another DI or BHC that uses the advanced approaches". It was our understanding from previous discussions that it was not intended to include intermediate subsidiaries of US BHCs in the definition of core banks.

We furthermore have a concern regarding the subsidiaries of international banks which fall under the well-capitalised and well-managed exemption pursuant to the Federal Reserve letter 01-01. In general, we appreciate this exemption and would suggest that it be maintained. However, whilst these entities would not have to comply with the minimum capital requirements, they would still have to comply with other Basel II aspects, including the required public and regulatory disclosures. This is problematic from our point of view

as public disclosures are only meaningful at the highest level and could at this intermediate level even be misleading, as they include for example intra-group capital movements. We would therefore suggest that bank holding companies that are subsidiaries of foreign institutions and meet the well-capitalised and well-managed standards be fully exempted from the Basel II requirements.

- *Pillar 2*

We note that the approaches taken in the EU and in the US with regard to Pillar 2 differ significantly. Whilst in Europe, the Committee of European Banking Supervisors (CEBS) has by now adopted a considerable number of guidelines for the application of the Supervisory Review Process, the US NPR leaves more scope for the gradual development of this part of the new solvency ratio regime. In our view there is merit in this approach. It remains to be seen how Pillar 2 will work in practice, and the hard-coding of detailed rules could be counter-productive at this stage. To ensure international consistency in the perception and application of Pillar II we would encourage the Basel Committee to lead an ongoing discussion and exchange of view on the practices applied in different jurisdictions.

Definition of Default

The NPR proposes a two-fold definition of default for wholesale and for retail exposures. For wholesale exposures, default is triggered by the non-accrual status, i.e. it includes well-secured past due amounts. For retail exposures, there are two benchmarks at 180 days and 120 days respectively. This is as opposed to the general 90 days definition of the Basel Accord.

These divergences are substantial. They impact on the core assumptions in the calculation of capital requirements, and especially on the isolation of the Probability of Default figures from Loss Given Default. Other things being equal, they are likely to result in lower PDs and higher ELGDs in the US, as compared to the data of an identical risk profile applied e.g. in the EU. As a result, banking groups would have different statistical series for their business in the US and elsewhere.

The implementation of dual systems can be problematic especially for banks' **wholesale business**. There is evidence that a significant share of banks' portfolio would be concerned by the divergence. Whilst we appreciate that the US proposal is based on the current rules, the consequences could be alleviated by **giving banks the choice of which definition to use for their US-based subsidiaries**. There might be reasons to opt for the US definition, such as to build on the existing local statistical series for SME loans or to ensure consistency for peer comparisons. On the other hand, banks should be given the possibility to use a consistent definition of default for their entire wholesale portfolio to ensure the global consistency of their models and statistical series.

For **retail activities** models can more easily be calibrated on local data based on the local rules. However, in this case banks should not be requested to compute their overall capital requirements on consolidated level on exclusively the home rules. Instead, we would call on the home supervisor to accept that in this case consolidated capital requirements be based on the local rules.

Estimation and floor of Loss Given Default (LGD)

According to the NPR, a bank must directly **estimate the parameters for loss given default (LGD) and for expected loss given default (ELGD)** for each wholesale exposure and each segment of retail exposures. LGD is defined as an estimate of the economic loss that would be incurred if the exposure were to default within a one-year horizon during economic downturn conditions. The LGD of an exposure may never be less than the exposure's ELGD. ELGD, on the other hand, is a bank's empirically based best estimate of the default-weighted average economic loss per dollar of EAD, which the bank expects to incur in the event that the obligor of the wholesale exposure defaults; or the loss the bank would expect to incur on a segment of retail exposures that defaults within a one-year horizon. The ELGD estimates must incorporate a mix of economic conditions.

These provisions deviate from the Basel Framework, which only requires banks to estimate a single LGD figure, equivalent to the (downturn) LGD of the NPR. By adding the figure of ELGD the NPR adds in prescription and, due to the late introduction of this requirement, creates a further systems challenge for banks in meeting the qualification requirements as set out in Section 22 of the NPR.

Unless explicitly authorised to use internal LGD estimates, banks will furthermore be required to apply a **supervisory mapping function** for converting internally estimated ELGDs into LGDs for risk-based purposes, which would de facto introduce an 8% floor for LGDs.

In addition, the formula-based measure of downturn LGD further increases the capital requirements for non-defaulted exposures compared with the Basel II Framework. This approach is neither proposed by the BCBS nor undertaken in any other jurisdiction and will therefore create an additional calculation and reporting burden for banks reporting under the advanced approaches both in the US and overseas, which is as opposed to the dialogue-based approach foreseen by Pillar II.

With regard to the agencies' invitation for comments on the determination of economic downturn conditions at a granular level, we emphasise that the LGDs for a given portfolio are already weighted according to the materiality of the segments. In our view, banks should not be required to estimate classes of LGDs except for subdivisions or subcategories of exposures chosen for their own calculations, which would be sufficiently representative. Requiring banks to build their models on particularly adverse LGD estimates on a granular level would also negate the principle of diversification.

In conclusion, we would suggest that the treatment of Loss Given Default be as much as possible aligned with the Basel II Framework.

Summary and Conclusion

The European Banking Federation wishes to express its continued support for the Basel II rules as they currently stand, and we emphasise the need for a truly international Accord that promotes increasing supervisory consistency and convergence. We call on the Basel Committee countries and at this occasion specifically on the US to keep divergences as limited as possible and, where problems are encountered, to seek solutions through a common discussion within the Basel Committee and its Accord Implementation Group. However, we would object to any changes being made at this stage to either the Accord or its European implementation and believe that these solutions should be entirely in line with the agreed Basel II framework. With regard to the timing gap of implementation in the US and the EU, we believe that solutions should to a large degree be built on the principle of

mutual recognition. Where significant divergences subsist, this principle might in some cases also have to be applied in the longer term.

We hope that you will find these comments informative. Please don't hesitate to contact me for any question you might have.

Yours sincerely,

Guido Ravoet