International Banking Federation

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Mr John M Reich
Director
Office of Thrift Supervision
Department of the Treasury
1700 G Street N.W.
Washington D.C. 20552

15th February 2007

Dear Mr Reich

Implementing Basel II in the US

We enjoyed meeting you yesterday to talk about how Basel II is being implemented in other parts of the world and how we would like to see it implemented in the US.

In short we hope that the Basel Framework will be implemented promptly and homogeneously in the United States of America, for the following reasons:

Prompt implementation will:

- ensure that banks – both US and non-US ones - face minimal extra costs because of staggered implementation. This will require them to maintain two sets of regulatory capital systems. The 1 year delay until 2009 in the US should not be allowed to slip any further.
- remove doubt about US supervisors' implementation plans, enabling banks to plan their businesses against a certain regulatory background. This will be good for users of banks products and services too.
- draw a line under the Basel II framework debate. This was developed after lengthy consideration amongst supervisors and effective consultation with industry. US regulators played a leading role in developing the new framework, which is robust and risk sensitive. It should be allowed to do its job.

Homogeneous implementation will:

- affirm all regulators' commitment to a global standard for the calculation of bank regulatory capital. Significant divergence from the Basel framework could even undermine the credibility of the Basel standard setting processes.
- enable banks to assess and manage similar risks in the same way regardless of the jurisdiction in which they are held. Requiring banks to use two different methodologies will double the implementation and validation effort without leading to a better risk management.

- permit regulators to rely on each others assessment of subsidiaries of an internationally active banking group. Banks to have multiple dialogues with home and host state regulators based on differing standards. Fostering such mutual trust is particularly important in the area of Pillar 2.

In addition we have concerns with the different approaches to interpreting the three key building blocks of Basel II – namely Probability of Default, Loss Given Default and Exposure at Default. These are detailed in the attachment to this letter. These different interpretations will require banks to implement conflicting requirements resulting in expensive additional data collection, modelling and reporting.

The answer to all these issues is a pragmatic approach that recognises that foreign banks should be able to adopt the same Basel II techniques in the US as are permitted by their home state regulator, based on the principle of mutual recognition and open dialogue. Building trust between regulators will ensure that the supervision of the banking system recognises the way in which internationally active banks actually manage their businesses.

Yours sincerely

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This attachment details our more specific and technical concerns about the NPR's approach to the three key parameters underpinning the new regulatory capital regime. Discusses their impact and proposes a solution.

Parameter Differences

1. Definition of Default

Both the Basel II framework and the Capital Requirements Directive (CRD)[1] establish explicit tests as to whether a default has occurred. Depending on the exposure category, an obligation that is between 90 and 180 days past due, is in default. In addition the CRD definition is subject to a materiality test. Also under the CRD a retail exposure may be treated as in default if the bank considers the obligor is unlikely to pay, for instance if the obligation is moved to a non-accrual status or offered for sale at a material[2] credit related economic loss.

In contrast the NPR establishes a 120 day past due test or 180 days for retail mortgages. For wholesale exposures the default test is based on a credit related loss of at least 5% of its initial amount in connection with its sale or transfer to an available for sale reporting category.

So the Definition of Default differs between Basel II/CRD and the NPR. Neither approach is intrinsically wrong, but the NPR Definition of Default differs from that recommended in the Basel II framework, which is being employed in all other major jurisdictions.

As a result foreign banks with banking subsidiaries in the US will have differing definitions of default depending on the location of the exposure, requiring them to run parallel systems for

[1] which implements the Basel framework in the 27 countries of the European Union
[2] undefined

regulatory capital calculation purposes. This will be resource intensive but not deliver added value

2. Loss Given Default

Both the Basel II framework and the CRD contain broad, common sense definitions of Loss Given Default (LGD).

US banks however will be subject to more onerous multiple LGD calculations. These are LGD, ELGD and supervisory LGD. Under the US proposals LGD is the ELGD[3] plus an estimate of the additional loss that would be caused by deteriorating economic conditions. Subject to supervisory approval, banks can use their own estimates to convert ELGD to LGD. Where such approval is not given the bank must use a supervisory mapping formula. This would require more capital to support a better quality exposure - which would have a low ELGD - than a lower quality exposure with a higher ELGD. This is counter-intuitive.

The mapping function effectively imposes an LGD floor of 8% on the particular category of exposure, or 10% for residential mortgages. As a result US banks will be subject to more conservative floors then those in the rest of the world.

3. Exposure at Default

Exposure at Default is not defined by either the Basel II framework or the CRD. The NPR does define EAD, requiring banks to estimate net additions to exposures. This will result in banks in the US collecting fee information – they are not required to do so in the rest of the world.

Impact

The impact of the differences in the definition of key Basel II framework parameters between the NPR and their definition in the rest of the world will cause significant implications for internationally active banks operating through subsidiaries in the US. Among these are:

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[3] a default weighted average LGD

data collection burdens

US subsidiaries of foreign banks will be required to collect data based on different definitions from these contained in the Basel II/CRD framework. This will create significant technology and data sufficiency burdens as banks that have already constructed data collection processes based on the Basel II definitions may not be able to re-engineer them in order to backfill data requirements to create the required US data history. Furthermore a paucity of loss data in the US subsidiary bank makes it difficult to provide parameters that are statistically significant to satisfy the use test.

use test

The NPR and Basel II/CRD both require banks to use the same key parameters in their risk management and internal capital allocation as they use it in their internal models. But the differing definitions of the three key parameters between the NPR and Basel II /CRD framework means that they will not be able to simultaneously satisfy both use tests.

reporting opacity

The disclosures of US banking subsidiaries of foreign banks will be based on different parameters to those used by the parent bank. Users of the reports required under Pillar 3 will find it very difficult to make meaningful comparisons between the US subsidiary and the parent bank.

The solution

Our preferred solution is for the US requirements to converge with those of the Basel II framework. These are already established and starting to be used in the rest of the world. Failing this a recognition by US regulators that US banks owned by foreign banks should be able to calculate their risk weights using their home country approach, based on the principle of mutual recognition.

Where capital requirement divergencies are identified - we doubt many will be - these can be addressed via bilateral dialogue between them US regulator and its overseas counterparts involving, where appropriate, the bank itself.

If mutual recognition proves difficult, in extremis, adjustments can be made through the Pillar 2 process.

But it is unlikely that either the US or home country approaches to the calculation of exposures will result in very dissimilar capital requirements as both the NPR and Basel II/CRD approaches contain multiple levels of conservatism.

We hope that US regulators will become comfortable with the processes being employed in other parts of the world. This will be achieved by active dialogue involving where necessary the bank itself. In this way unnecessarily duplicative implementation requirements can be avoided and the new, more risk sensitive regulatory capital regime delivered in a more cost effective way.