

MEMORANDUM

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**TO:** Public File  
**FROM:** Karen Osterloh, Special Counsel  
**DATE:** August 15, 2006  
**RE:** Basel II NPR  
Summary of OTS meeting with Institute of International Bankers

**Attendees**

On August 3, 2006, OTS met with representatives of the Institute of International Bankers (IIB). The following individuals attended:

At OTS Headquarters:

OTS Scott Albinson  
Grovetta Gardineer  
Michael Solomon  
Fred Phillips-Patrick  
David Tate  
Kevin Anderson  
Karen Osterloh

Via Telephone

IIB Lawrence Uhlick  
Ken Bachman

**Summary of Discussion**

IIB raised the following issues relating to the implementation of the Basel II Accord across international borders:

Host issues

- IIB expressed concern regarding how the Basel II NPR will impact banks located in the U.S. that are subsidiaries of international banking operations.
  - Foreign banks with U.S. branches do not appear to be a concern since FRB has indicated it will continue to use standards similar to existing standards, as supplemented by information on compliance with the home country's implementation of the Basel II Accord.
- With respect to U.S. compliance, these banks will have to conform to the US rules.
  - IIB applauded Director Reich's statement of May 6, 2006 that he intended to support making the upcoming Basel IA changes optional, since many international banks operating in the US would not be core or opt in banks and, therefore, would not be forced to make capital changes in response to Basel IA.

- IIB also expressed support for offering the standardized approach (including an operational risk component) in the U.S. since this option would ease the compliance burdens for international banks.

#### Specific issues regarding lack of uniformity for banks implementing the Basel II Accord.

- IIB expressed concern that the international authorities are not implementing the Basel II Accord uniformly, which raises significant compliance burdens for banks that operate internationally.
- IIB has developed a checklist of inconsistencies between the U.S. Basel II NPR and the Capital Requirements Directive (CRD) of the European Union.
  - IIB noted that these inconsistencies raise not only serious data maintenance problems, but also systems development issues.
  - IIB's list is attached to this summary.
- IIB expressed particular concern regarding differences between the E.U. and U.S. definition of default.
  - Among other items, the CRD definition of default will look to whether the bank determines that the obligor is "unlikely to pay," which would include non-accrual status (which is addressed in the U.S. definition of wholesale default) and other events.
  - IIB noted that the OCC has requested it to ask its members to sample loans data to determine whether these definitional differences result in significant or insignificant differences in capital computations.
  - IIB offered to provide the results of these surveys to OTS.

#### Home issues.

- IIB noted that one method for the resolution of national differences is for the home country to accept the capital requirements for foreign subsidiaries as calculated under the host country's rules. Under this scenario, capital requirements for foreign operations would simply be aggregated at the parent level rather than recalculated under the home country's rules. As a result, banks would not be forced to calculate the capital requirement for these foreign operations using two separate systems.
- OTS stated that it intends to address these issues in conformance with U.S. rules, through bilateral discussions on a case-by-case basis. IIB indicated that banks will need information on how these differences will be resolved early in the development process so that they may incorporate the information in the data and modeling decisions.

## **Check List of Inconsistencies and Differences between Advanced Methodologies Under the NPR and CRD**

1. **Asset Securitization Maturity Mismatch in Synthetic Securitizations**  
In case the tenor of the credit derivative is shorter than the longest tenor out of the securitized asset pool, the tenor of the credit derivative must be taken most conservatively. Capital build-up is required starting 5 years before the maturity date of the program and gradually increases. We believe that expiry of credit protection should be dealt with through the capital planning process rather than artificially via RWA.
2. **Definition of Default (page 109)**  
In case banks must use for host supervisory purposes another definition for default than used for consolidated group and internal purposes, compliance with the one obligor, one rating requirement group-wide is impossible. Furthermore, for internationally syndicated loans, it is undesirable that different default definitions apply in different jurisdictions. In addition, there will be issues in the area of cross border rating validation, use test, mapping to external ratings and, for some banks, in the setting of correlation parameters. We believe that the definition of default, that has been discussed intensively prior to the establishment of the Basel Accord, is one of the key elements where regulators need to align with each other.
3. **Supervisory Mapping Function (page 120)**  
In case banks are not able to provide own ELGD estimates (downturn), an imposed supervisory mapping function must be used de facto leading to a minimum LGD of 8%. Especially for daily revalued, but not daily re-margined financial collateral, this function is too conservative. Also for back to back facilities, this is overly conservative as cash collateral is not impacted by downturn conditions.
4. **Defaulted Assets (page 138)**  
The newly introduced RWA calculation for defaulted assets is effectively ensuring that the RWA result for defaulted assets can never be lower than RWA pre-default. The newly introduced formula has two repercussions: 1. the floor seems to penalize intermediary downgrades prior to default, and 2. upon default suddenly collateral recognition is disallowed. We believe the first issue leads to a disincentive to apply an adequate ratings process. As to the second, we are of the opinion that the formula is conceptually flawed, and recommend to replace LGD with an estimate of the specific recovery of the exposure in question.
5. **Double Default (page 81)**  
Double Default may only be used if the US supervisor has given permission. Our opinion is that given that the double default treatment is already rather limitative and that the formula is straightforward, we do not see the rationale why in addition permission must be given. This raises the question whether additional intransparent requirements will be imposed.

**6. Asset Securitization; Securitized Asset Types (page 166)**

For the full securitization treatment to apply, solely financial assets can be securitized assets (i.e. no music and film rights). For non-financial assets, the RBA may apply. But if not rated or no inferred rating available, then capital deduction will be applied, which is extremely severe. We do however not understand the rationale behind the more penalizing capital treatment for non-financial assets.

**7. CRM: Financial Collateral (page 201)**

The highest collateral haircut for investments in funds has to be applied. The impact of this is high as margins in this type of business are often thin. We believe that it would be more appropriate to require banks to apply a weighted average collateral haircut.

**8. EAD for Asset Based Lending (page 123)**

The idea of having the effect of pre-default paydowns recognized is fully supported by us. The impact of this effect can be rather high, provided that banks can validate this by their history. Our experience is that history will prove this indeed.

**9. LGD Floor (page 120)**

The LGD floor indicates that LGD must be at least equal to ELGD. Banks in question will conduct further research on the phenomenon of a negative correlation between PD and LGD. The conservative mapping function is given for the floor. Is this formula coming in place for the margin of conservatism that is currently applicable?

**10. Retail Segmentation (page 172)**

It is stated that retail segments should not cross national jurisdictions. Some jurisdictions are cross-border (e.g. CRD in Europe. We assume that this is more about jurisdiction than nationality. Can the agencies confirm this?

Furthermore, in our opinion it cannot be excluded that in the future in certain Asian countries retail segments cover portfolios in more than one country. Especially asset-based lending (e.g vendor finance) is standard in many Asian countries. In this sense, the statement limits flexibility and good business practice of banks.

**11. Retail Seasoning Effects (page 115)**

*Seasoning effects, if deemed material must be taken into account in retail PD. In our opinion this can be qualified as rather challenging as we believe that this cannot be validated. We therefore propose to make this optional.*