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Karen Shaw Petrou
Executive Director

January 18, 2006

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, DC 20219
Docket Number 05-16

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Docket Number R-1238

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552
Attention: No. 2005-40

Dear Sir or Madam:

The Financial Guardian Group (FGG) is pleased hereby to comment on the agencies' advance notice of proposed rulemaking (ANPR) on a revised risk-based capital regime generally known as "Basel IA." The FGG focuses on regulatory capital issues of particular concern to specialized U.S. banks active in asset management, payments processing and other fee-based activities. We have been actively engaged in the Basel decision-making process since 2001 and appreciate very much the care with which our views to date have been considered. We particularly appreciate that the agencies have

agreed that regulatory capital can and often does have profound competitive impact, with the Basel IA option now on the table to ensure that adoption of Basel II will not have unanticipated and adverse impact on the nation's banking system.

In this letter, the FGG would like to emphasize the following points:

- It is most appropriate that the Basel IA framework does not include a capital charge for operational risk. None should be added as the IA proposal advances. The agencies should focus on improving supervisory standards applicable to operational risk and, when these are finalized, adopt them as part of the Basel II Pillar 2 requirements, deleting the regulatory capital charge for operational risk as proposed for Basel II's Pillar 1 component.

- It is important for U.S. regulators to move quickly on Basel IA even if the Basel II changes remain under consideration. Basel IA creates an appropriate initial new risk-based capital (RBC) framework that lowers capital for proven low-risk assets and raises it – sometimes considerably – for proven high-risk assets. The approach does not have the models risk, complexity and other concerns that remain with Basel II, and thus it will help quickly to advance the agencies' safety-and-soundness objectives.

- Because of the safety-and-soundness benefits of the IA approach, there should be no floors on its adoption in comparison to Basel I capital requirements. Regulators have retained their right to increase RBC as appropriate on a case-by-case basis under Basel IA, and this is sufficient to ensure no undue RBC reductions at institutions without effective internal risk management and other needed controls. Such floors would also have an adverse competitive impact on U.S. banks versus international ones under the Basel II standardized credit risk framework (which has no floors). The floors may be appropriate only in connection with Basel II's advanced options due to their complexity and the fact that these approaches have yet to be tested in an economic downturn.

- To the degree that leverage and prompt corrective action (PCA) thresholds are maintained, they should be applied only to insured depositories, not to parent holding companies. This ensures appropriate protection for the deposit insurance funds, although the ratios should be revised so they do not create a strong incentive against risk management – the entire point, of course, of the Basel risk-based capital exercise. Holding companies are not protected by the FDIC nor does the implicit "too-big-to-fail" protection apply to them or their non-banking affiliates. It is thus appropriate that regulatory capital at the parent company be consolidated without inclusion of specific capital charges intended only for insured depositories. Congress has made clear that bank capital standards should not apply to holding companies.

- The FGG supports the proposed approach to credit risk, especially reliance on external ratings. We believe this is a simple, yet effective, way better to align RBC with risk. We would urge the agencies to use their flexibility to hike capital as needed for unrated obligations, rather than issue a complex set of additional credit RBC standards, to ensure that institutions do not avoid external ratings on riskier holdings unduly to reduce RBC.

- Because Basel IA is not one of the Basel Committee's options, serious questions are raised about how internationally-active U.S. banks that elect to use Basel IA can comply with host-country Basel II requirements and how the U.S. will consider capital adequacy outside the U.S. for purposes of total bank and holding-company capital adequacy. It is recommended that the U.S. accept use of the Basel II standardized credit-risk options, as these are closest to Basel IA and thus will reduce the home/host differences that create undue burden and, perhaps, barriers to entry.

- Basel IA does have significant economic impact, as discussed in more detail below. Thus, advance review by the Office of Management and Budget (OMB) of any final rule pursuant to Executive Order 12866 is appropriate.

The agencies have also asked for comment on whether small U.S. banks and savings associations should be permitted to remain under Basel I even as the IA and II rules are implemented. A $500 million asset threshold is likely for institutions electing to remain under Basel I if the Federal Reserve finalizes its proposal to permit institutions at this higher minimum threshold to be excluded from current capital requirements.[1] The Federal Reserve has rightly conditioned this proposed exclusion on the degree to which an institution confines itself to traditional banking, making clear that it would not apply to entities with off-balance sheet or fee-based business lines. Any exclusion from Basel IA for smaller institutions should contain similar conditions due to the degree to which such banks can sometimes be formidable competitors in specialized lines of business. The agencies should also, as the Fed has proposed, expressly retain the right to subject smaller institutions to higher regulatory capital or Basel IA if prudential considerations warrant.

I. Operational Risk

As noted, the FGG is pleased that the agencies have decided against operational risk-based capital (ORBC) charges in the Basel IA context. In our prior Basel II comments, we have provided detailed discussions of ORBC.[2] Although some of our concerns relate to the adverse international impact of an ORBC charge – due, for example, to the Basel II charge for legal risk – many of the problems with a Basel II ORBC requirement also apply in the Basel IA context.

Of particular concern is the fact that there is no accepted methodology or measure for operational risk. The U.S. agencies have thus worked hard on the advanced measurement approach (AMA) in Basel II, arguing that this provides sufficient flexibility to accommodate widely-different ORBC methods and specific institutional circumstances. The FGG accepts much in the AMA methodology, but we have argued that all of these variations – not to mention the complexity of the AMA – make it more appropriate within the Pillar 2, not Pillar 1, context. In the Basel IA framework, the AMA is inappropriate precisely because of these complexities and differences. The more simple approaches to ORBC – the "basic indicator" and "standardized" options available outside the U.S. – are, while simple, wholly skewed because the percentages of gross income on which these ORBC charges are based have no relationship to actual operational risk.

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[1] *Capital Adequacy Guidelines for Bank Holding Companies, Small Bank Holding Company Policy Statement, Definition of a Qualifying Small Bank Holding Company*, Proposed Rule, Board of Governors of the Federal Reserve, September 8, 2005.
[2] See attachment.

In addition to the problems related to complexity and unreliability, a specific capital charge for operational risk raises another grave concern in the Basel IA context: perverse incentives. Operational risk mitigation is essential, as a series of recent natural disasters and the constant terrorist threat make all too clear. It is also very expensive and demanding. The AMA attempts to take account of some risk mitigation, although it remains deeply flawed because of the very limited recognition of proven types of operational risk insurance. Its complexity and cost, however, militate against the limited offset for risk mitigation provided, and many institutions may thus come to focus more on capital compliance than on actual operational risk identification, mitigation, control and recovery. This is a frightening thought for the nation's very largest banks and still worse when extended to all of the others that would come under Basel IA.

Finally, we would note that U.S. bank regulators – in sharp contrast to their international peers – cannot extend their RBC rules to non-banking organizations. Non-banks are major players in fee-based lines of business that would come under the ORBC charge, but no comparable requirement applies to most of them. Thus, lines of business like asset management and payments processing would have a regulatory capital incentive to migrate from banks to non-banks – a move with unnecessary competitive impact on banks and undesirable prudential implications for bank regulators.

It is thus commendable that the agencies have in Basel IA decided against an operational risk-based capital charge. The FGG applauds this and urges a continued focus in U.S. and international regulation on proven forms of operational risk mitigation.

II. Timing

The banking agencies have proposed to make the Basel IA rules effective on the same schedule as Basel II. The latter schedule was announced by the agencies in late September.[3] Under it, Basel II would not be fully effective until 2012 or, perhaps, even longer due to the reservations noted by the agencies. The FGG is concerned that this long Basel II delay, combined with the very high floors then announced, will pose potentially significant competitiveness problems for large, internationally-active U.S. banks, as well as create undue RBC incentives for foreign acquisition of U.S. banks and savings associations. The lengthy delay also keeps all of the current incentives for regulatory arbitrage in place for years, creating the serious potential for safety-and-soundness problems as yet more financial instruments are engineered around the increasingly anachronistic Basel I standards.

To avoid these problems, the agencies should make Basel IA final as quickly as possible, mandating it for all but any small entities they choose to exempt. The agencies may then move on to finalize Basel II and, as proposed, mandate its adoption for "core" banks and savings associations, as well as providing that qualified smaller institutions may elect Basel II as desired. All insured depositories would thus come under Basel IA, with the largest then required to comply with Basel II as these standards are finalized and each institution complies with the eligibility requirements.

III. Floors

[3] *Banking Agencies Announce Revised Plan for Implementation of the Basel II Framework*, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, September 30, 2005.

As noted, the agencies have indicated that they plan not only a longer phase-in for Basel II than contemplated under the final international accord, but also higher and longer floors on the amount of capital that may be reduced. The FGG believes that there should be no such floors under the Basel IA regime and we commend the agencies for not suggesting this in the ANPR. The agencies have, however, rightly proposed to retain their flexibility to hike regulatory capital for any institution that appears to be unduly risky. This flexibility is, we believe, more than sufficient to ensure against undue regulatory capital reductions under the Basel IA framework, especially in light of the leverage and prompt corrective action (PCA) requirements (see below).

IV. Leverage and PCA Standards

As noted, the agencies have proposed to keep these in place under Basel IA, consistent with the proposal to do the same under Basel II. The FGG has long expressed concern about this policy, noting that these standards will create perverse incentives against all of the risk management and mitigation ones at which the entire RBC rewrite exercise is aimed. Proponents of the standards argue that they are necessary to protect against unwise drops – some fear even precipitous ones – suggested by the agencies' fourth quantitative impact survey. However, as noted in our prior comments, the QIS4 results are not a good indicator of actual Basel II capital once credit RBC is appropriately stress-tested and other criteria not addressed in the study are calculated.

However, to the degree that the agencies decide to retain the leverage and PCA thresholds, this should be done only for insured depositories, not for parent holding companies. While regulatory capital can be consolidated at the holding-company level, as required under Basel II, unique U.S. banking-agency provisions such as the leverage requirement should not apply outside insured depository affiliates.

In fact, Congress has made clear that it does not want bank or savings-association style capital applied to parent holding companies. The PCA standards expressly apply only to insured depositories, not to parent holding companies.[4] In 1999, Congress also expressly mandated that financial holding company activities may be limited based only on subsidiary insured-depository capital adequacy, not that of the parent holding company.[5] Indeed, it is most unclear if the Office of Thrift Supervision even has authority over capital adequacy at parent holding companies of savings associations. Although the agency may be a "conglomerate" regulator,[6] its ability to assess its parent companies is based on agreements by such firms that OTS may do so. Without such authority, Congress has given the agency only limited authority over savings association parent firms.[7]

Some may counter that it is necessary to apply these standards at the holding-company level to prevent regulatory arbitrage. This is, however, inappropriate for both competitive and supervisory reasons. First on the competitiveness point, as noted, it is unclear if OTS could impose these standards at the holding-company level, especially when unitary thrift holding companies are controlled by non-banking organizations. Thus, application of such standards would differentiate between bank and savings-association parents in an unnecessary and inappropriate fashion that might encourage charter choice. Secondly, the Securities and Exchange Commission has not imposed a leverage requirement or standards comparable to the PCA ones in its rules applying Basel II standards to "consolidated

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[4] 12 U.S.C. § 1831o.
[5] P.L. 106-102.
[6] *Regulatory Bulletin RB 35: Large and Complex Enterprises (Conglomerates)*, Office of Thrift Supervision, November 20, 2003.
[7] 12 U.S.C. § 1467a.

supervised entities,"[8] nor has the Commodity Futures Trading Commission proposed this in comparable rules under consideration for futures commission merchants.[9] A decision by the agencies to mandate bank and/or financial holding company consolidated capital with leverage and PCA standards would thus also pose a competitive problem for institutions with significant investment banking and similar activities.

From a supervisory point of view, it is also unnecessary to impose the leverage or PCA standards. The Federal Reserve has ample authority to ensure that holding-company activities do not pose undue risk to insured-depository affiliates without recourse to the leverage and PCA standards. For example, the Board has extensive authority under the recently-revised Sections 23A and 23B of the Federal Reserve Act to ensure that inter-affiliate transactions do not threaten insured depositories.[10] The Board also has broad authority to ensure that holding companies are able to act as a "source of strength" to subsidiary insured depositories.[11] Finally, the Board has recently adopted a new supervisory framework for bank holding companies designed to ensure that non-banking affiliates are operated in a safe and sound fashion.[12] All of this, the FGG believes, is more than sufficient to ensure that holding companies will be managed in a prudential fashion without the need to apply leverage and PCA standards to them.

V. Credit Risk

Members of the FGG have in the past argued for a simplified approach to credit risk for institutions with low-risk portfolios, which is often the case at specialized banks that focus on fee-based businesses. At these institutions, assets are generally held as collateral or other forms of security for fee-based activities, not as portfolios from which earnings are derived. These assets thus play a very different role than is the case at more traditional banks, obviating the need for much of the complexity – and, of course, the burden – of the advanced internal ratings-based approach in Basel II.

The FGG is pleased that the Basel Committee has recently recognized this in a proposed new way to deal with low-risk portfolios.[13] We also appreciate the proposed approach to credit risk in the Basel IA proposal. External ratings are, we believe, a valid way to assess credit risk, as evidenced by widespread industry and supervisory reliance on them (see, for example, the ratings-based approach in the agencies' recourse capital rule).[14] To the extent the agencies believe an institution may lack sufficient internal controls or otherwise poses undue risk despite these ratings, the retained authority to increase RBC noted above provides them with sufficient flexibility.

Our only caveat with regard to the proposed use of external ratings is that the weighting for unrated assets would remain at 100%. This could create an opportunity for institutions expressly to avoid external ratings for holdings they know would receive a high-risk one that would hike RBC. The

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[8] 12 CFR Parts 200 and 240.

[9] *Alternative Market Risk and Credit Risk Capital Charges for Futures Commission Merchants and Specified Foreign Currency Forward and Inventory Capital Charges*, Proposed Rules, Commodity Futures Trading Commission, October 11, 2005.

[10] 12 USC § 371c-1 and 12 C.F.R. Part 223.

[11] 12 C.F.R. 225.4(a)(1) and *Board of Governors* v. *First Lincolnwood Corp.*, 439 U.S. 234 (1978).

[12] *Bank Holding Company Rating System*, Supervisory Letter SR 04-18, Board of Governors of the Federal Reserve System, December 6, 2004.

[13] *Basel Committee Newsletter No. 6: Validation of low-default portfolios in the Basel II Framework,* Bank for International Settlements, Basel Committee on Banking Supervision, September, 2005.

[14] 12 C.F.R. Parts 3, 208, 225, 325, and 567.

agencies should make clear in the Basel IA framework that institutions should establish policies and procedures to prevent that and that examiners will carefully assess this issue and impose higher RBC on unrated obligations as appropriate.

VI. Home/Host Concerns

The Basel Committee has rightly focused on the question of how home- and host-country supervisors can reconcile their interests as Basel II is implemented, most recently issuing a consultative paper on this important question.[15] Home/host issues are particularly problematic for internationally-active U.S. institutions, including FGG members. Problems are raised by the different schedule on which Basel II may be implemented here, the leverage and PCA requirements (unique to the U.S.) and – germane to this comment – the IA framework. The latter is also unique to the U.S. While it bears similarities to the standardized credit risk approaches in Basel II, the IA standards are still sufficiently different as to raise home/host coordination concerns. Additionally, the pending U.S. proposal not to allow internationally-active U.S.-domiciled banks to use the standardized option outside the U.S. for significant subsidiaries also raises major coordination problems. Failure to resolve them will impose a significant regulatory burden on U.S. institutions, which would need to comply with widely-disparate capital regimes for no discernible prudential purpose. It could also pose serious barriers to entry outside the U.S. if international regulators fail to accept Basel IA as a comparable regulatory regime under the "conglomerate" rules applicable within the European Union or similar international standards.[16]

The FGG recommends that U.S. agencies work with their international counterparts to obtain formal recognition of the Basel IA framework. This would ensure that internationally-active banks that elect this here will not have to run "parallel" Basel II capital books at their parent company levels to continue to operate outside the United States. It would also minimize home/host concerns for non-U.S. banks active in this market, limiting the degree to which such institutions could use regulatory arbitrage to engage in merger-and-acquisition business here. We recognize that U.S. banks operating outside the U.S. would need to adopt a Basel II option in host countries, but formal IA recognition would limit the burden this will pose.

VII. Economic Impact

The OCC and OTS are, as noted, required pursuant to Executive Order 12866 to determine if pending rules have significant economic impact, and comment on this question has been solicited. The FGG has long argued that the Basel rules meet the Executive Order criteria for economic impact and we strongly believe that the Basel IA rules would have major impact and thus must be subject to prior OMB review.

The agencies have yet to formalize the IA framework into a specific NPR, which makes quantification of its potential impact difficult at this point. However, even very rough estimates make clear how significant the rule could be. At the close of the third quarter of 2005, all U.S. insured depositories had regulatory capital of $1.09 trillion.[17] Subtracting the capital of the nine entities likely to be "core"

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[15] *Home-Host Information Sharing for Effective Basel II Implementation*, Consultative Document, Bank for International Settlements, Basel Committee on Banking Supervision, November 22, 2005.

[16] *Directive 2002/87/EC*, The European Parliament and the Council of the European Union, December 16, 2002.

[17] *Quarterly Banking Profile: Third Quarter, 2005*, Federal Deposit Insurance Corporation, November 22, 2005.

banks subject to Basel II from this total leaves $593 billion.[18] We do not for purposes of this calculation attempt to address the question of whether some small institutions would be exempt from Basel IA and thus from the following capital calculation since the size of any such exemption is at this point speculative. Thus, we would suggest that the amount of regulatory capital held by banks and savings associations likely to be subject to Basel IA is now the $593 billion cited above. Were Basel IA to raise or lower this 1%, the impact of this change is $5.9 billion – well above the $100 million criterion for economic impact to the private sector.

Importantly, the proposal could have significant impact even if the total amount of regulatory capital somehow remained unchanged under Basel IA. In its third-quarter, 2005 data, the FDIC noted that commercial real estate accounted for 7.5% of insured-depository assets. Based on the $593 billion of regulatory capital for Basel IA institutions noted above, this means that $44 billion is held against commercial real estate credit risk. It is the expectation of the agencies that the more risk-sensitive approach under Basel IA would increase commercial real estate-related regulatory capital. Assuming a 10% increase, this would mean a $4.4 billion change – again well above the $100 million criterion.

One might refute the above assertion by arguing that the Executive Order criterion is not met if, despite the commercial real estate impact noted above, this is offset by capital reductions elsewhere to leave the total amount of industry regulatory capital relatively unchanged – a result possible if the leverage and PCA thresholds are retained and left unchanged. However, even then the FGG believes a significant – if currently unquantifiable – economic impact would occur. Regulatory capital is a major driver of lender business decisions – if it were not, the entire Basel exercise would be little other than a theoretical one designed to improve internal models. Holding all other factors constant, regulatory capital is a powerful incentive for pricing and, thus, profitability. If RBC changes along the lines suggested for the commercial real estate requirement above, then substantial changes in the types of credit available and its pricing would ensue. In-depth research on how this would work is possible only with a more refined proposal, but it is clear that any of the changes contemplated for Basel IA could have far-reaching national economic consequences.

The Financial Guardian Group would be pleased to provide additional information or address any comments you may have on the views expressed here. We remain grateful to the agencies for their ongoing work to ensure that the U.S. imposes risk-based capital rules that are as simple as possible, that align regulatory with economic capital to the greatest degree possible, and that are set with due regard for their competitive impact at home and abroad.

Sincerely,

Karen Shaw Petrou
Executive Director

[18] The difference between the total system capital and the aggregate capital of Citigroup, Bank of America, JP Morgan Chase, Wells Fargo, Wachovia, Washington Mutual, Deutsche Bank, State Street, and Bank of New York.

Attachment

The Financial Guardian Group has filed formal comment letters responding to the following:

Quantitative Impact Study 4 and *Loss Data Collection Exercise*, the Federal Financial Institutions Examination Council, August, 2004.

Advanced Notice of Proposed Rulemaking on Risk Based Guidelines and the Implementation of the New Basel Capital Accord, Board of Governors of the Federal Reserve, Comptroller of the Currency, Office of Thrift Supervison, Federal Deposit Insurance Corporation, August, 2003.

Third Quantitative Impact Study and *Operational Risk Loss Data Collection Exercise*, the Bank For International Settlements, Basel Committee on Banking Supervision, May, 2003.

Proposed Treatment of Expected and Unexpected Losses, the Bank For International Settlements, Basel Committee on Banking Supervision, April, 2003.

Third Consultative Paper of the New Basel Capital Accord, the Bank for International Settlements, Basel Committee on Banking Supervision, April, 2003.

Sound Practices for the Management and Supervision of Operational Risk, Bank for International Settlements, Basel Committee on Banking Supervision, Risk Management Group, February, 2003.

Transparency Standards Pillar 3 – Market Discipline Draft Version, Bank for International Settlements, Basel Committee on Banking Supervision, December, 2002.

Consultation Paper 142: Operational Risk Systems and Controls, Financial Services Authority (United Kingdom), July, 2002.

Supplement of October 31 Comment Letter: Working Paper on the Regulatory Treatment of Operational Risk, Bank for International Settlements, Basel Committee on Banking Supervision, Risk Management Group, September, 2001.

Working Paper on the Regulatory Treatment of Operational Risk, Bank for International Settlements, Basel Committee on Banking Supervision, Risk Management Group, September, 2001.

Second Consultative Package, the Bank for International Settlements, Basel Committee on Banking Supervision, January, 2001.