SUNGARD®
SunGard • BancWare ERisk • www.erisk.com • 1500 Broadway, 18th Floor, New York, NY 10036 • 212-819-0170 *tel* • 212-819-0171 *fax*

16 January 2006

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave., NW
Washington, D.C., 20551

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, D.C., 20219

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C., 20429

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, D.C. 20552

Re: Comment on Proposal: Risk-based Capital Guidelines
Board Docket number: R-1238
OCC Docket No. 05-16
FDIC RIN 3064-AC96
OTS RIN 1550-AB98

Ladies and Gentlemen,

Thank you for this opportunity to comment on the October 20, 2005 Advanced Notice of Proposed Rulemaking (ANPR) for Basel I-A. We applaud the Agencies' continued efforts to manage the competing objectives and priorities relating to the Basel II policy debate, as well as the Agencies' pursuit of more advanced risk measurement and management practices.

We submit these comments on behalf of BancWare ERisk, a consulting and software solutions firm that delivers risk modeling and capital management products and services to a broad range of banking organizations, including money center, regional and community banking firms.

Unlike many of the respondents to this request for comment, we are not a financial institution and therefore have no direct stake in the absolute level of capital required by regulators. We are, however, strong advocates of better risk and capital management in banking both as a matter of safety and soundness and as a key component in superior financial performance.

Background to our comments
One of the fundamental objectives of the Basel II process was to provide incentives for banking organizations to improve their risk measurement and management processes. To our taste, the debate over Basel II focused too much on the development of a risk-sensitive rules-based minimum capital adequacy framework (Pillar I), rather than on a principles-based approach for promoting improved risk management practices.

However, Pillar II of Basel II went much of the way towards redressing this imbalance, and the new Pillar I rules at least encouraged banks to take a relatively granular approach to identifying risk drivers and to gather better risk data.

We are worried that, in this respect, the ANPR for Basel I-A is a step backwards. The proposed changes in the ANPR seem to focus even more firmly than the early Basel II debate on revising the rules surrounding minimum capital adequacy, and they largely ignore the problem of how to encourage banks to improve their data and risk management practices.

Indeed, the Agencies seem to believe that banks will be able to implement the changes outlined in the ANPR using data already available as part of each organization's credit approval and portfolio management processes.

We doubt that this is the case, but more importantly we think that it misses an important point.

We are convinced that an important policy goal for capital adequacy reform in the United States should be a framework of mutually self-reinforcing guidelines and rules that encourage progressively more advanced risk measurement and management principles, models and data.

This basic goal should apply to the regulation of the regional and community firms likely to be covered by Basel I-A, as well as to the larger and more complex banks covered by Basel II. As well as setting out clear principles, we think that any new rules for U.S. banks should create incentives for firms to invest in the data and models that underpin their risk management capabilities.

Although the ANPR creates lower regulatory capital for products that are important to smaller organizations, most notably mortgages, the rules-based nature of the framework inevitably remains somewhat inflexible and suffers from many of the same structural rigidities as the 1988 Accord. We therefore believe that supervisory discretion and flexibility must be a part of this revised set of capital rules and any implementing supervisory regulations and policies.

We would urge policy makers to strengthen their proposals in four key areas:

(1) Consider creating a Pillar II-style provision that provides incentives for banks to adopt enhanced risk modeling and management principles
(2) Encourage firms to begin to capture risk data that is essential to improving their risk modeling at an appropriate level of granularity (including systems improvement)
(3) Avoid trying to mend the inflexibility of a rules-based scheme by introducing a "trifurcated" or even "quadrifurcated" U.S. capital regime, as this will only increase the dangers of adverse selection and capital arbitrage while reducing transparency
(4) Address the lack of comprehensiveness in the present proposals by introducing some principles-based mechanism that encourages firms to look at all their risks, not only credit risk

I. Enhanced Principles of Risk Management and Pillar II-Style Reform

Basel II set in motion a lot of good work that is already beginning to permeate the U.S. banking system. In particular, it laid out various guiding principles of risk measurement that look set to become 'sound practice' in the global banking industry. Many U.S. banks that had no intention of becoming Basel II-compliant have adopted these principles as a matter of sound practice – and have then found that they can build on this investment to improve their competitive standing.

In our business practice, many of our smaller and regional bank clients are pursuing, like their large bank competitors, more advanced risk measurement systems and altering their internal risk management structures to adapt to innovations within the banking sector. Quantitative risk measurement tools are not only being used to drive traditional transaction-level decisions but increasingly inform strategic enterprise-wide decisions such as risk-based credit limit setting, credit portfolio management, customer value management and product and market selection.

We feel that much of the language in the ANPR undermines this ‘Spirit of Basel’ effect by suggesting that it is not worthwhile for less sophisticated banking organizations to invest in risk management. This couldn’t be further from the case, as many smaller banks suffer from significant concentrations in terms of geography, industry, and product offerings that are best managed by improving quantitative risk management.

We would like to encourage the Agencies to continue advocating the principles of Basel II to the Basel I-A constituency of banks. Furthermore, the Basel I-A regime should allow regulators to differentiate banks that adhere to a set of well-described principles and practices from those that fall short of these high standards. While this might imply some enhancements in the skill-set and deployment of bank supervisory resources, it is surely in the public interest to give banks incentives to increase their sensitivity to risk.

II. Incentives for Improving Data and Systems

The current ANPR proposes only a moderately more granular risk-weighting scheme without any provision for regulatory capital relief for firms that create more advanced risk management processes, but that also choose to remain outside the Basel II tent.

While we appreciate the need for sensitivity regarding costs and regulatory burden, we don’t believe that the opportunity to encourage some quite specific advanced risk practices across the U.S. industry should be sacrificed for the sake of expediency.

Regulators should use this opportunity to encourage banks to improve their rating systems and to better quantify the other risk factors (parameters) that drive their portfolios. In particular, regulators should encourage banks to use internal data where possible, and to focus on risk factors that are most relevant to the particular organization in question. They should encourage banks to follow the sound credit practices laid out in Basel II, for example in terms of establishing dual rating systems, associating ratings with objective probabilities of default, and improving scoring models. Our experience suggests that all these approaches can be successfully implemented at smaller institutions.

In the context of Basel I-A, we believe the bank supervisory authorities, nominally the primary supervisor for the national, state-member or state non-member banks, should be able to receive petitions for capital relief by constituent banks for specific product portfolio(s) where the bank can demonstrate best-practice risk and capital management.

This kind of ‘positive incentive’ structure, possibly including the public disclosure of review and approval decisions, would allow a tighter alignment between the principles, practices and incentives of Basel II and non-Basel II firms. It would short-circuit, to some degree, the debate over competitive advantages of Basel II versus Basel I-A firms, and push banks in the right direction with regard to improved data, analysis, modeling and risk oversight.

III. Adverse Selection and Capital Arbitrage

The ANPR seems to open up the possibility of multiple capital regimes within the U.S. While some banks may be permitted to remain on Basel I, others will move to Basel I-A, and still others will move to a blend of Basel I and Basel I-A.

We are concerned that multiple capital regimes will create a confusing morass of rules with three worrying outcomes.

Firstly, the confusion will harm the broader Basel II-goal of increased transparency throughout the banking system. It will undermine the regulators' hope that market discipline, based on a clearer investor understanding of bank risk, will push banks towards better risk and capital management.

Secondly, creating a trifurcated or quadrifurcated system will open up a Pandora's Box of opportunities for capital arbitrage that we believe would be best avoided.

Thirdly, the process of adverse selection – a worry even under a bifurcated regime – is likely to become even more complex and difficult to understand. We think that one fundamental regulatory aim should be to make sure that firms take on the kind of risks that they are best able to understand and to manage. However, if a hierarchy of sophisticated-to-simple capital regimes is allowed to evolve, we will find that larger firms with more advanced risk measures begin to shed high-risk loans that do not command a market price in line with their capital costs. These loans will tend to migrate towards the portfolios of smaller firms operating under Basel I (or Basel I-A, or some mixture). These firms will be relatively insensitive to the true economic cost of the risk associated with the loans because they will receive a regulatory capital 'subsidy' for holding such loans – and will also not have been prodded by their regulators to improve their risk measurement capabilities.

IV. Lack of Comprehensiveness

The ANPR obliges banks to calculate regulatory capital with regard to only one type of risk: credit risk. We think that the ANPR should push banks to calculate their capital adequacy in relation to other risks as well.

The regulators are quite right to be wary about introducing complicated rules-based schemes for these other risks, which potentially include operational, market, interest rate and other risks.

Instead, we would suggest that they encourage banks to move their risk and capital management in the right direction using some principles-based language. This language should be published within the broad context of a Basel I-A proposal, and might consist of an interagency statement consistent with the Four Key Principles of Supervisory Review found in Basel's Pillar II.

Alternatively, the Agencies might look for a template in the Federal Reserve's Supervisory Letter 99-18, entitled "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles". This is a good example of a principles-based document that advocates enhanced capital measurement across risk-classes.

V. Technical Considerations

Once the aforementioned comments have been addressed, some of the details of the proposed rules described in the ANPR could be enhanced. For example, we would like to draw your attention to some of the following observations:

- The ANPR emphasizes the use of Loan-to-Value ratios as a way of differentiating between the risks of various transactions. However, in our opinion it may not be practical to use LTV in this way. The relevant information is not always captured in bank systems in a manner that would allow for regulatory reporting. Where the information is captured (e.g., in the automated valuation systems used in larger banks) it is often not re-valued periodically to reflect potentially significant changes in property prices.
- We believe that using other additional risk factors such as FICO scores, debt/income and loan age would help to improve the differentiation of risk, but most banks would have to create new systems to capture this data. Nonetheless, firms that chose to do so might be ideal candidates for the kind of capital relief based on better risk measurement that we mentioned earlier in this letter.
- We feel that the ANPR should specify how to treat Credit Conversion Factors (CCFs) for various kinds of products. We think that CCFs would need to vary, depending on whether the bank has an exposure to a

construction loan, a credit card, or even products such as negative amortization loans, which, in effect, are open lines of credits.

- The ANPR's treatment of defaulted loans (e.g., loans 90 days or more overdue, or in non-accrual) should reflect the extent of the recovery risk associated with these loans. This risk can have a substantial impact on Economic Capital and, as a result, on risk-weighted assets.

We hope that these comments prove helpful and we would welcome the opportunity to discuss them further.

Sincerely yours,

Thomas Day
Product Manager
BancWare
Thomas.Day@risk.sungard.com

Shahram Elghanayan
Managing Director
BancWare ERisk
selghanayan@erisk.com

Hans Helbekkmo
Managing Director
BancWare ERisk
hhelbekkmo@erisk.com

Brannan Johnston
Managing Director
BancWare ERisk
bjohnston@erisk.com