Capital One

Capital One Financial Corporation
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McLean, VA 22102

Via E-mail and Hand Delivery

January 18, 2006

Jennifer J. Johnson
Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue,
N.W.
Washington, DC 20551
Docket No. R-1238

Office of the Comptroller of the
Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, DC 20219
Docket No. 05-16

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552
Attn: No. 2005-10

Mr. Robert E. Feldman
Executive Secretary
Attn: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
RIN 3064-AC96

Re: Risk-Based Capital Guidelines

Dear Sirs and Madames:

Capital One Financial Corporation ("Capital One") is please to submit comments in support of the federal banking agencies' Advance Notice of Proposed Rulemaking on the subject of Risk-Based Capital Guidelines.

Capital One Financial Corporation is a financial holding company whose subsidiaries Capital One Bank, Capital One, F.S.B., and Capital One Auto Finance, Inc., offer a variety of consumer lending products. Capital One's subsidiaries collectively had 49.2 million accounts and $84.8 billion in managed loans outstanding as of September 30, 2005. Capital One is a Fortune 500 company, and through its subsidiaries, is one of the largest providers of MasterCard and Visa credit cards in the world.

In addition, Capital One recently completed its acquisition of Hibernia Corporation, a full-service commercial bank holding company, that, as of September 30, 2005, had $23.2 billion in assets and 326 locations in Louisiana and Texas.

Summary

Capital One strongly supports the federal banking agencies' (the Agencies) initiative to revise the Basel I capital regime to make it more risk-sensitive. We view the principles underlying the initiative to include:

- Increasing the sensitivity of risk weights without unduly increasing the burden of compliance

- Creating a risk-weighting scheme that can be consistently and fairly applied to institutions of all sizes and complexities

- Establishing a risk-weighting scheme that supports overall safety and soundness

- Using the best evidence and analysis to calibrate the risk-weighting scheme, rather than relying on prior assumptions or compromises

Capital One would applaud any modifications to the existing regulatory regime that embrace these principles.

Further, we believe that we can provide assistance to the Agencies in developing the evidence and analysis necessary to calibrate the risk-weighting scheme for unsecured retail credits, in particular for credit cards. Our approach to that subject follows.

I. Risk Weights for Unsecured Consumer Credits Can Feasibly be Based on FICO Scores (Advance Notice, part II.F)

Capital One welcomes the Agencies' proposal to increase the number of risk-weight categories for retail exposures such as credit cards. If adopted and applied to credit card exposures, we believe the revision will usefully increase the risk sensitivity of capital requirements for this type of exposure. And, we specifically endorse the Agencies' suggestion that "[o]ne approach that would increase the credit-risk sensitivity of the risk-based capital requirements for other retail exposures would be to use a credit assessment, such as the borrower's credit score . . ."

We believe that FICO®[1] scores provide the obvious tool for assigning risk weights to domestic unsecured consumer credit, especially credit card balances. FICO scores are almost universally recognized and used as a key measure of consumer credit risk. While they are not the sole or even the primary means of making credit and pricing decisions (Capital One, like other lenders, relies on proprietary credit decisioning models that include many factors in addition to FICO scores), the value of FICO scores for a risk-weighting scheme lies in their being reasonably correlated with credit loss and

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[1] FICO is a registered trademark of the Fair Isaac Corporation.

hence, with capital needs, as well as being universally available to all lenders. Further, valid FICO scores are available for almost all credit card borrowers.[2]

Credit bureaus can provide refreshed FICO scores at a cost that is insignificant in comparison with the amounts of capital that are held against credit card accounts. Further, credit bureaus provide those scores in an automated format that requires very little manual processing. Most credit card lenders already maintain systems and databases that track refreshed FICO scores, because that information is a critical element in managing outstanding credit card balances and credit limits. In fact, with the SEC's adoption of Regulation AB, public credit card issuers are already required by regulation to maintain refreshed FICO scores for credit card accounts that have been securitized. Smaller institutions are also able to obtain these scores easily. Hence, the use of FICO scores to segment and risk-weight credit card balances will place no undue burden on U.S. credit card lenders.

Furthermore, industry "rules of thumb" segmenting credit quality of card accounts by FICO score correspond logically with the expanded number of risk-weight categories suggested by the Agencies. FICO scores in excess of 720 are typically considered "superprime," the 660-720 range is considered "prime," 600-660 "near prime," and below 600 "subprime," with a demarcation at 540 identifying a deeper subprime population. We propose that these bands be used to assign risk weights to domestic credit card accounts. Lenders managing their card accounts in distinct, relatively homogenous pools might assign all accounts in a particular pool to one segment on the basis of the mean or median FICO score of the accounts in that pool.

Using those FICO segments and using industry default data, we recommend risk weight categories based on consumer FICO scores as shown in the following table (derivation described below):

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[2] Data from the Equifax credit bureau suggest that fewer than 1% of existing credit card accounts and balances lack a valid FICO score.

[3] Equifax data suggests that fewer than one percent of existing card accounts and card balances lack a valid FICO score

Table 1 – Suggested Risk Weight for Credit Card Exposures in Different FICO Segments[3]

Proposed FICO Range	One-year PD	Risk Weight derived using Basel II Formula	Basel IA Suggested Risk Weight	% of Total US Credit Card Balance
<540	18.24%	279%	350%	3%
540-600	8.63%	182%	200%	6%
600-660	4.45%	116%	150%	20%
660-720	1.94%	63%	75%	33%
720+	0.27%	13%	20%	38%
Total	2.74%	69%	86%	100%

To construct this table, after identifying the five broad credit card segments enumerated above, we set out to assess the PD (probability of default), LGD (loss given default), and EAD (exposure at default) corresponding to these segments. This information, combined with an AVC (asset value correlation) assumption, can quantify an appropriate risk-weight using the Basel II A-IRB credit risk formula.

The PD is derived from the Beacon 5.0 validation chart published by Equifax (24 month cumulative default rate for Bank National Revolving Accounts, performance data from July 1998 to July 2000). This two-year cumulative default rate was translated into the one-year PD estimate shown by assuming a constant monthly charge-off rate.[4] Our calculations assume an LGD of 91.7 percent (weighted average LGD for QRE in the QIS4 exercise) and EAD of 180 percent of initial outstandings. The EAD figure is derived as the product of the QIS4 weighted-average credit conversion factor of 22.2% for QRE and the aggregate amount of open-to-buy (open credit limit) on existing U.S. credit card accounts: 368% of existing drawn balances (estimate based on Equifax data). Thus, among loans that default within the next year, lenders typically anticipate roughly 80 cents of additional draws for every dollar of existing balances.

The final parameter needed to derive the Basel II–equivalent capital charge is the asset value correlation, or AVC. Rather than using the 4% AVC assumption stated in the Basel II proposal, we use a 2% AVC that more closely aligns with our internal experience. To derive AVC estimates, we first segment millions of accounts into homogeneous risk buckets using internally generated risk scores that rank-order borrowers by default likelihood. We then measure the volatility of historical loss rates

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[3] Data in this table for Probabilities of Default, and for percentages of total U.S. credit card balances attributable to different FICO ranges, are derived from Equifax credit bureau data.

[4] We also annualized the Equifax two-year default rate by examining the historical monthly charge-off experience in our own portfolio and found the results to be substantially similar.

for each risk-bucket and derive the Loan Default Correlation (LDC) among borrowers. LDCs are then translated into AVCs using a mathematical formula. These AVC estimates anchor our internal economic capital modeling. Our data suggests that AVCs for credit cards are well below 2% across the entire credit spectrum. Unfortunately, industry AVC data is scarce. The one study we are aware of, the Risk Management Association's 2003 publication "Retail Credit Economic Capital Estimation – Best Practices," surveyed six credit card lenders and concluded that credit card AVCs are less than 4%. The RMA has recently contacted a number of lenders about updating this industry research, and the results may be available to guide the Agencies' prospective rulemaking.[5]

As the Basel II formula identifies a capital amount rather than risk-weight, we additionally assume a minimum capital requirement of 8% to derive the calculated risk weights shown in column three of our table. The suggested risk weights shown in the fourth column round the calculated weights to the nearest risk-weight bucket considered in the Advance Notice. Adoption of these proposed risk weights would culminate in an industry weighted-average risk-weight of 86 percent.[6]

This risk-weighting scheme accomplishes the Agencies' objectives of creating a more risk-sensitive standard while minimizing logistical overhead and burden. Segmenting card accounts by FICO is not unduly burdensome, and the mapping of these FICO ranges to risk-weights employs the rigorous A-IRB formulae of Basel II without the need for individual banks to derive and corroborate their own PD, LGD, and EAD

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[5] We understand that the 4% AVC proposed for credit card portfolios for Basel II was influenced by negotiated agreement with international regulators -- as evidenced by the change in AVC treatment between the Third Consultative Paper and the final Accord. However, we submit that accurate risk weightings for U.S. portfolios must be based on the best data that are specific to the U.S. credit card industry.

[6] Using the ten percent prompt-corrective action "well-capitalized" threshold, a more relevant minimum capital figure for US institutions, would reduce the risk-weights in Table 1 by twenty percent.
[6] Using the 10% Prompt Corrective Action threshold of "well capitalized," a more relevant minimum capital figure for U.S. institutions, would reduce the risk-weights in Table 1 by 20%.

[7] This risk-weighting scheme is also superior to the capital guidance provided in the Agencies' "Expanded Guidance for Subprime Lending Programs," now four years old. The deficiencies of the capital aspect of that Subprime Guidance in comparison with the risk-weighting scheme proposed above are at least threefold. First, the Subprime Guidance used a single credit-risk dividing line of FICO 660, rather than segmenting portfolios into five buckets based on FICO scores. Second, for the population thereby characterized as "subprime" (below FICO 660), the Subprime Guidance authorized a capital-charge increase of 50-200%, but did not provide examiners with any rigorous, statistically based guidance on how to exercise their discretion within that range. Finally, the Subprime Guidance applied only to targeted subprime-lending programs, whereas our experience shows that the credit risk of a subprime (or other) credit card account does not vary depending on whether it was acquired through a marketing program directed at the FICO segment within which the account is categorized.

estimates. This five-bucket risk-weighting scheme is far more refined and meaningful than the uniform risk weight assigned in Basel I.[7]

Further, the use of FICO scores to assess capital charges would not unfairly impact lower-income borrowers. FICO scores are based on a large number of factors that are statistically correlated with risk of default, especially those related to the actual behavior of the borrower, notably the borrower's payment history. No factor, including income, is given more weight than is statistically correlated with risk of default.

II. Other Matters

a. Unconditionally cancelable commitments

Capital One agrees that unconditionally cancelable commitments, such as credit card open-to-buy, should continue to receive 0% credit conversion factor. Holding capital against open-to-buy is equivalent to precapitalizing future growth of the credit card portfolio. When the customer draws on the open-to-buy, then the institution should capitalize the additional outstanding. If an institution becomes straitened for capital it can cancel the open-to-buy.

Using a credit conversion factor of 0% suggests an EAD of 100% rather than 180% as used in Table 1 above. Applying that revised EAD, Table 1 would be recalculated as follows:

Table 2 – Alternative Suggested Risk Weight for Credit Card Exposures in Different FICO Segments (100% EAD)

Proposed FICO Range	One-year PD	Risk Weight derived using Basel II Formula	Basel IA Suggested Risk Weight	% of Total US Credit Card Balance
<540	18.24%	155%	150%	3%
540-600	8.63%	101%	100%	6%
600-660	4.45%	65%	75%	20%
660-720	1.94%	35%	35%	33%
720+	0.27%	7%	20%	38%
Total	2.74%	38%	45%	100%

b. Small business loans

Capital One suggests that certain revolving small business loans – business credit cards – be risk-weighted in a manner similar to that described above for retail credit cards. Many credit card issuers lend to individuals and small companies for business purposes. As with personal credit cards, these loans are managed in pools. Underwriting principles are similar, with lenders placing great emphasis on the credit-worthiness of the principals. As such, we believe the risk-based capital treatment of this type of exposure should be aligned with that of consumer credit card exposures. We strongly support the second alternative suggested in the Advance Notice, that risk-weights to small business loans be based on a credit assessment of the business principals.

c. Capital treatment of securitizations

Capital One does not agree that a capital charge should be assessed on the investor's interest in credit card securitizations. In a securitization, the risk of credit loss passes to the investors. While the possibility of early amortization is genuine (though rare), it is fundamentally a risk of *liquidity,* not *credit*. Unexpected credit loss might help trigger early amortization, but those losses are shared among the issuer and investors as dictated by the legal terms of the securitization. Once early amortization commences, funding, not credit performance, is the issuer's primary concern. For this reason, early amortization is not dissimilar from other liquidity crises a lender might face. The recognized means for dealing with liquidity risk is not capital, but sound liquidity management – funding-source diversity, back-up lines of credit, and a strong capital market presence. Sound liquidity management is likewise the appropriate instrument for addressing the risk of early amortization. Stated another way, early amortization is not an insolvency risk if the issuer can obtain alternative funding. For this reason – and the significant regulatory capital requirements that card issuers already face with respect to recourse and retained subordinate tranches – no additional capital charge for investor's interest is appropriate.

Should the Agencies nevertheless go forward with their proposal to assess a capital charge on the investor's interest, the charge should be tied to excess-spread levels rather than levied at a flat rate. As noted in the Advance Notice, the risk of early amortization is directly tied to excess spread, so any capital charge should reflect the likelihood of the risk as expressed by the spread. The spread-based charge would also align more closely with Basel II capital rules, minimizing competitive disparities across the regimes.

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Capital One appreciates the opportunity to comment on the Advance Notice of Proposed Rulemaking and commends the Agencies for initiating this project. If you have any questions about this matter and our comments, please call me at (703) 720-2255 or Geoffrey Rubin at (703) 720-3102.

Sincerely,

/s/

Christopher T. Curtis
Associate General Counsel
Policy Affairs