October 27, 2008

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

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

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

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: OTS-2008-0002

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework; 73 Federal Register 43982; July 29, 2008; **OCC:** Docket ID: OCC-2008-0006, RIN 1557-AD07; **FRB:** Docket No. R-1318; **FDIC:** RIN 3064-AD29; **OTS:** Docket No. 2008-002, RIN 1550-AC19

Ladies and Gentlemen:

The Risk Management Association (RMA) is pleased to comment on the Notice of Proposed Rulemaking (NPR) issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the Agencies) that proposes new Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework (henceforth, "Standardized NPR"). As the Agencies are aware, RMA has been actively involved in the effort to reform the regulatory capital guidelines for the past decade and fully supports a more risk- sensitive alignment of regulatory capital standards. Exposures that have higher risk should require more capital; and conversely, lower-risk exposures should require less capital. Clearly, in an appropriately risk-sensitive capital regime, capital will either be higher or lower based on risk.

RMA applauds the efforts of the Agencies to promulgate the Standardized framework in the U.S. The Standardized elements of the International Accord have been implemented in all major banking jurisdictions, and across the globe banks of all sizes are complying with this version of Basel II at some or all of their legal entities. We acknowledge that the Standardized version of the Accord is significantly less risk-sensitive than the Advanced version. Still, the Standardized version represents a meaningful progression in regulatory risk-capital guidelines and risk management. Extreme market volatility only heightens the importance of a risk-sensitive regulatory regime; regulators should embrace

Standardized Basel II as a means of ensuring the sufficiency of bank capital while stimulating safe lending. For these reasons, we support the swift finalization of the Standardized Framework, notwithstanding the amendments suggested here.

RMA has attempted to provide as much detail as possible in our response to the NPR and with our answers to the 21 questions it poses. Our attached response notes the areas of the Standardized framework that might be further improved, such as the expanding the options for operational risk calculation to include all those provided for in the international accord. It is our hope that the Agencies will find our input useful and we stand ready to be of any further assistance that you may deem appropriate. Please feel free to contact me at 215-446-4052 or via email at edemarco@rmahq.org, or Pam Martin, our Director of Regulatory Relations, at 215-446-4092 or email at pmartin@rmahq.org.

Sincerely yours,

Edward J. DeMarco
General Counsel

Pamela Martin
Director of Regulatory Relations

Encl.

Response to the U.S. Notice of Proposed Rulemaking

Risk-Based Capital Guidelines;
Capital Adequacy Guidelines: Standardized Framework

Risk Management Association

October 27, 2008

I. Introduction and Overview

RMA is pleased to present this response to the July 29, 2008 publication of the Notice of Proposed Rulemaking ("NPR") dealing with the U.S. banking agencies' implementation of the Standardized Basel II capital adequacy guidelines ("Standardized"). Our Group remains a staunch supporter of the move toward best-practice, risk-sensitive, minimum capital requirements. As such, we believe that the standards published by the Basel Committee in June, 2004 (the "Accord"), and recently supplemented in light of existing market conditions, dramatically improve the ability of regulators to assess the safety and soundness of financial institutions in world markets. We encourage the U.S. Agencies to adopt all aspects of the International Accord, including the Standardized provisions considered in the present NPR.

RMA responded to earlier requests for comment at various stages of U.S. Accord implementation. These responses emphasized the importance of creating a risk-sensitive regulatory capital framework with minimal impediments. While we affirm these earlier comments and our continued support of enhanced risk-sensitivity and risk management, we will focus our comments here on the Standardized NPR. Section II develops the general themes of our response and the highlights our most urgent proposed modifications. Section III addresses the 21 questions posed in the NPR.

II. Points of emphasis

We attempted to make this response comprehensive by replying to all 21 questions and including additional observations and suggestions, but we do not want our primary points of emphasis to get lost. If we can impress only four items on the Agencies, they would be:

1. The Standardized NPR is a great improvement over Basel IA and the Agencies should aggressively move to finalize this rule. Some areas of the NPR can be improved but, on balance, the Standardized NPR is an unambiguous step forward for the industry and its regulators. Recent market events redouble the urgency of implementation. Now, more than ever, capital requirements should shift to the riskiest assets and banks. None of the comments provided here should be interpreted as requiring a slower pace of adoption or major rework.
2. The Agencies should allow banks to calculate their operational risk capital charge with either the Standardized Approach or the Alternative Standardized Approach that are provided for in the International Accord. Please see our response to Question 19 for additional detail.
3. The Agencies should provide clear guidance to banks and examiners on how to interpret the determination of "well-diversified" portfolios for inclusion in the regulatory retail asset class. Please see our response to Question 11 for additional detail.
4. Banks should be permitted to update the estimate of home value when calculating LTV and risk-weights for seasoned loans. The proposed rule for deriving LTV strongly discourages the retention of seasoned loans on the balance sheet and will further encourage the securitization, piggy-back second liens, and third-party transactions that have been so often faulted in the recent credit crisis. In normal markets, home prices appreciate at the pace of inflation or slightly above; over a ten or twenty-year holding period, this appreciation can have a material impact on home

value, LTV, and risk. But the NPR prohibits the re-underwriting of home value over time unless there is a transaction – refinancing, modification of loan terms, or addition of a second-lien. We argue that regulators should encourage the retention of safe, seasoned loans and allow banks to order updated appraisals to demonstrate more relevant LTVs and risk-weights over time. We certainly expect that regulators will require updated appraisals and LTV estimates during periods of *falling* home prices, so the same dynamic should be available when prices are increasing. In sum, LTV based upon current, rather than origination, home value is the relevant economic concept driving credit performance and capital need. If the Agencies choose to dismiss this metric, the market will adapt by arbitraging the rule – the creation of one-dollar second liens for the purpose of obtaining an updated home value and lower LTV/risk-weight is a perverse but realistic example. Unless market prices are falling, we do not suggest mandatory updated appraisals -- banks unwilling to pay for updated appraisals will simply hold excess capital against their mortgages. But if the agencies want banks to once again hold residential mortgages to maturity, it is imperative that they be allowed to recognize current home value in any LTV measure.

III. Responses to NPR Questions

Question 1a: The agencies seek comments on all aspects of this proposal, including risk sensitivity, regulatory burden, and competitive impact.

The risk-sensitivity of the rule could be improved in a number of ways:

1. Permitting the use of loan-to-value (LTV) or debt-service-coverage (DSC) ratio buckets for commercial real estate exposures. The use of LTV buckets to differentiate risk and capital requirements is a prudent, practical means of enhancing risk-sensitivity for residential mortgages. The same approach can be applied to commercial mortgages. Commercial mortgage portfolios are perhaps the most prevalent asset class on US bank balance sheets. Existing regulations acknowledge that CRE risk depends critically upon underwriting standards such as LTV and DSC ratios. We strongly suggest that LTV and/or DSC ratios be used to assign risk-weights to CRE assets, as both the default and recovery rates for conservatively underwritten exposures are significantly different than those with high LTV's and low DSC's. Differentiating CRE risk-weights on the basis of these characteristics will appropriately match risk with capital requirements in this asset class. In fact, existing RTCCI legislation considers multi-family exposures with DSC in excess of 120% sufficiently safe to merit a reduction in risk-weight from 100% to 50% This type of risk differentiation will greatly improve the assignment of risk-weights to all CRE. Capital requirements for institutions that target high-risk CRE (LTV in excess of 90% or DSC less than 120%) should exceed the requirements of institutions focused on extremely low-risk CRE (LTV less than 50% or DSC in excess of 200%). RMA feels that CRE differentiation can be implemented by banks with the same reasonable effort that is required for residential mortgage differentiation.

2. The use of FICO or other vendor-supplied credit scores to differentiate risk among retail exposures. FICO scores are a well-known, consistent, and widely-available measure of risk for retail exposures, a notion acknowledged by regulators in existing Subprime Guidance and Regulation AB rules. These scores provide an objective, comparable measure of portfolio risk. A portfolio with an average FICO score of 600 is, all else equal, more risky than one with an average of 750; the riskier portfolio should be assigned a higher risk-weight. We understand that these scores are imperfect and that examiners would need to consider other portfolio risk features under Pillar Two, but historical loss rates in the retail subprime lending sector should be sufficient to convince the Agencies that FICO scores contain useful risk information. Maintaining updated FICO scores might be challenging, particularly for smaller institutions, so providing an option for banks to segment their retail portfolios by FICO scores might be a workable solution.
3. Incorporating features of the "Foundational" approach from the International Accord. The Accord anticipates that some banks not yet prepared for A-IRB might still profitably deploy their internal risk measurement systems for the calculation of regulatory capital. RMA feels that a number of larger, non-core institutions fit this mould. Many banks in the $10B to $250B range are unprepared for full-blown A-IRB but have well-functioning, well-documented internal risk rating systems that appropriately reflect the default probability of larger C&I and CRE exposures. If the Agencies were to incorporate elements, if not the entirety, of the Foundational approach, this import risk information could be put to use in the assignment of risk-weights.

We feel that the above enhancements to risk-sensitivity should be incorporated into the Pillar One risk-weighting framework on either a mandatory or optional basis. Lacking that, we encourage the Agencies to emphasize this important risk information in their Pillar Two assessments. Banks with low-risk CRE, C&I, and retail exposures – whether measured by LTV, FICO, or internal systems – should be levied progressively lighter capital requirements than their riskier counterparts.

Question 1b: The agencies seek comment on the advantages and disadvantages of the use of external credit ratings in risk-based capital requirements for banking organizations and whether identified weakness in the credit rating process suggests the need to change or enhance any of the proposals in this NPR. The agencies also seek comment on whether additional refinements to the proposals in the NPR should be considered to address more broadly the prudent use of credit ratings by banking organizations. For example, should there be operational conditions for banking organizations to make use of credit ratings in determining risk-based capital requirements, enhancements to minimum capital requirements, or modifications to the supervisory review process?

RMA acknowledges the recently demonstrated shortcomings of external ratings but still feels they usefully differentiate risk and should be adopted in the manner proposed in the NPR. Some observations about the use of external ratings

1. Regulatory scrutiny of the ratings process should fall on the rating agencies, themselves, not the users. Requiring hundreds or thousands of smaller institutions to conduct corroborating due-diligence on extremely low-risk debt is tremendously inefficient. The rating agencies serve the useful purpose of making appropriately priced debt more accessible.
2. In particular, examiners should be sensitive to the role of publicly-rated exposures in the bank's core strategy. Banks that only acquire highly-rated exposures for the purpose of building a safe, diverse, and well-yielding investment portfolio should not be burdened with developing a sophisticated counterparty risk function. Conversely, banks that rely heavily on such exposures or move more aggressively down the credit curve should be expected to measure and manage these risks more precisely.
3. The vast majority of US banking organizations lack publicly rated counterparties in their banking book. In all but the largest few dozen banks – most of which will adopt the Advanced – the only publicly-rated exposures are in the investment portfolio.

Despite the recent, well-publicized default and devaluation of highly-rated exposures, public ratings still usefully differentiate risk. The default likelihood of recent AAA-rated MBS issues might exceed the historically-implied 0.01 percent default likelihood, but they are still significantly less risky than BBB- or BB-rated exposures and should be treated as such in the regulatory capital rules. Given the alternatives – requiring bank-by-bank underwriting or ignoring risk altogether, the proposed use of public ratings seem the most prudent approach. And again, regulators can use the lever of Pillar Two in those instances where a higher degree of oversight is merited by the breadth and type of exposures.

Question 1c: The agencies seek commenters' views on what changes to the approaches set forth in this NPR, if any, should be considered as a result of recent market events, particularly with respect to the securitization framework described in this NPR.

The BIS has addressed recent market turmoil with proposed modifications to market risk and trading book capital requirements. The RMA intends to respond to the specific US implementation if and when these modifications are published in a proposed US rule.

Question 2: The agencies seek comment on the proposed applicability of the standardized framework (to various entities within a larger corporate entity) and in particular on the degree of flexibility that should be provided to individual depository institutions within a corporate family, keeping in mind regulatory burden issues as well as ways to minimize the potential for regulatory capital arbitrage.

RMA understands and supports the aim of the Agencies to limit regulatory capital arbitrage within a banking organization. The proposed compliance requirements seem reasonable, though we encourage the Agencies to consider and more completely define "materiality" in this regard. In cases where minor subsidiaries pose little risk to the larger banking organization, full compliance at the subsidiary seems an excessive burden.

This is particularly true for Pillar Two requirements. RMA strongly suggests that the ICAAP and other Pillar Two requirements be required only at the top-tier consolidated level rather than at each subsidiary. This top-level ICAAP should, of course, consider the adequacy of the capital position at each material subsidiary. It should also consider the extent to which various legal entities are able and expected to support one another. Permitting banks to create a single, integrated Pillar Two submission will both reduce burden and create a more thoughtful analysis of capital adequacy at the bank and its most important elements.

Question 3: The agencies seek comment on whether or to what extent core banking organizations should be able to use the proposed standardized framework.

The Advanced regime is certainly more risk-sensitive and appropriate for institutions with complex exposures and activities, but asset size is a crude litmus test for assessing complexity. Very large institutions with simple business strategies and portfolios might be more suited to Standardized, while smaller, more complex institutions are better served by the Advanced approach. Perhaps the criteria for core status should be modified, giving supervisors more discretion in determining when institutions should be compelled to follow Advanced. Additionally, supervisors could be authorized to require certain risk-management activities -- such as the ICAAP (or SR 99-18) or securitization risk-quantification -- without demanding full-fledged Advanced Basel II compliance. However, regulators should discourage the practice of examiners turning SR 99-18 exams into exhaustive Pillar II exams for Basel I banks.

We also recommend that core A-IRB organizations be permitted to use the proposed standardized framework for small portfolios and for a reasonable period following mergers. The advanced rule provides that core banks may exclude certain immaterial exposures from the A-IRB computations and also provides for the use of the general risk-based capital rules to determine capital requirements for a period of time when merging with a bank that does not use the Basel advanced approaches. In both cases, the resulting capital requirements have little or no risk sensitivity. The rules in the proposed Standardized Framework offer advantages both to banks and to supervisors in producing capital requirement that are more aligned with risks in these situations.

Question 4: Given the potential for three separate definitions of tier 1 capital under the three frameworks, the agencies solicit comment on all aspects of the tier 1 leverage ratio numerator, including issues related to burden and competitive equity.

RMA discourages the creation of a “leverage ratio” tier 1 capital figure that is distinct from the “risk-based” tier 1 capital figure. If this inconsistency is untenable, we suggest that the Agencies create a tier 1 capital figure that is consistently defined across the various regimes by converting the regime-specific tier 1 capital additions/deductions into risk-weights (the denominator).

Question 5: The agencies seek comment on the use of solicited and unsolicited external ratings as proposed in this NPR.

Smaller institutions rarely lend directly to rated corporate entities, but a well-diversified, high-yielding investment portfolio is important for all institutions. The use of public ratings is an important tool for putting these instruments in the reach of smaller banks. Again we reiterate that regulatory scrutiny of the ratings process should fall on the agencies, themselves, not on the users. Requiring hundreds or thousands of smaller institutions to conduct corroborating due diligence on the credit characteristics of structured products is tremendously inefficient.

Question 6: The agencies seek comment on this proposed approach (use of ratings to risk-weight exposures to regulated financial entities), as well as on the appropriateness of applying the alternative approach to exposures to depository institutions, credit unions, and foreign banks.

While the alternative approach of using public ratings to risk-weight financial entity exposures has more appealing risk-sensitivity, the practical difficulties (lack of ratings for many financial entities) of such an approach in the U.S. are untenable. As such, RMA supports the proposed use of sovereign ratings to assign risk-weights to financial entity counterparties. We only note that the risk-weight applied to the safest financial entities under Standardized – 20% -- will greatly exceed the risk-weights available under Advanced, which could go as low as 3%. The Agencies should anticipate the competitive implications of significantly different regulatory capital requirements across regimes in this area.

Question 7: The agencies seek comment on the pros and cons of the proposed approach for risk weighting exposures to PSEs as well as on the appropriateness of applying, instead, the approach proposed in this NPR for depository institutions.

RMA generally agrees with the proposed approach for PSE's, which is more risk-sensitive than the alternative approach. We do, however, encourage the Agencies to revisit the differentiated risk-weights for general obligation and project revenue bonds that exist under the current general risk-based capital rules. Both the probability of default and loss-given default for general obligation bonds are lower than for their project revenue counterparts; this difference might be reflected in distinct risk-weighting tables for these types of exposures.

Question 8: The agencies solicit comment on the use of short-term ratings for exposures to PSEs generally and specifically on the ratings and related risk weights in Table 4.

We support the proposed use of short-term ratings. The use of short-term ratings enhances risk-sensitivity, better incents and aligns portfolio construction, and puts Standardized banks on more equal footing with Advanced institutions.

Question 9: The agencies seek comment on the appropriateness of including either or both of these aspects (of using short-term corporate ratings to infer risk-weights) of the New Accord in any final rule implementing the standardized framework.

RMA argues that the use of short-term corporate ratings to infer risk-weights provides useful risk-sensitivity where the alternative provides none. We suggest that the Agencies consider developing an appropriate means of inferring risk-weights on unrated corporate exposures in those cases where short-term ratings are available.

Question 10: The agencies seek comment on the use of financial strength ratings to determine risk weights for exposures to GSEs, and seek comment on how such ratings might be applied. The agencies also seek input on how subordination and maturity of exposures could be embodied in such an approach, and what requirements should be developed for recognizing ratings assigned to GSEs.

We presume that the proposed NPR treatment for Fannie and Freddie has been superseded by recent events, so our comments here refer only to exposures of any GSEs that might maintain their existing status. Regulators need to carefully balance regulatory burden with adherence to regulatory principles. While we understand the desire to isolate the implicit U.S. guarantee in assigning risk-weights, deciphering stand-alone risk-ratings for each GSE obligation is overly burdensome. We recommend that risk-weights be driven by readily available public ratings. The RMA is issuing separate comment on the proposed change in risk-weights for Fannie Mae and Freddie Mac obligations.

Question 11: The agencies seek comment on whether a specific numerical limit on concentration should be incorporated into the provisions for regulatory retail exposures. For example, the New Accord suggests a 0.2 percent limit on an aggregate exposure to one obligor as a measure of concentration within the regulatory retail portfolio. The agencies solicit comment on the appropriateness of a 0.2 percent limit as well as on other types of measures of portfolio concentration that may be appropriate.

RMA feels that the determination of "well-diversified" portfolios for regulatory retail treatment is among the most important provisions of this regulation. It is imperative that the Agencies provide additional clarity for examiners and banks on how to assess portfolio diversification. The 0.2 percent limit to a single obligor is a useful, but certainly not comprehensive measure. Obligor type, obligor industry, asset class, vintage, maturity, base rate, and collateral type also contribute to economic diversification. The multi-dimensionality of the diversification problem makes for more difficult regulation, but RMA argues that it must nonetheless be addressed.

Examples of the dangers of using one-dimensional measures of diversification:

1. The use of a hard limit on proportional obligor size might encourage excessive lending to different obligors in the same industry. Alternatively, banks might pursue facility structures that circumvent a simple rule on size.
2. A hard limit on counterpart geography is particularly dangerous, as smaller banks – at the behest of their examiners -- intentionally focus their lending efforts within their geographic footprint.
3. Even the $1mm absolute size limit for inclusion in the regulatory retail asset class is questionable for institutions with very large balance sheets.

RMA suggests that the Agencies issue concise but robust guidance for examining diversification. This guidance could cover the span of diversification measures and support more meaningful assessment of diversification. We also suggest that examiners adhere to a high burden of proof before concluding that a portfolio does not meet the definition of "well-diversified". The lack of direction on diversification provided in the NPR is of little help to banks and examiners trying to build balance sheets that are both well-diversified and appropriately risk-weighted. We strongly argue that the Agencies clarify this issue prior to finalizing the rule.

Question 12: The agencies request comment on all aspects of the proposed treatment of PMI under this framework (recognizing loan-level PMI but not pool-level PMI in determining LTVs and risk-weights)

RMA agrees that loan-level PMI should be recognized as an important mitigant in assigning risk-weights. The agencies should clarify, however, whether loan-level PMI shall be used solely in deriving LTV ratios and risk-weights for the entire notional exposure, or whether the PMI also reduces the effective size of the exposure, itself. Consider the following example.

Loan size:	\$900,000
Home value:	\$1,000,000
Loan-level PMI:	Covers loss on loan amount in excess of 80%, or the first \$100,000

In this example, the effective LTV as calculated in the NPR is 80%, so the exposure would be assigned a 35% risk-weight. But the NPR is not clear whether this 35% should be assigned to the \$900,000 gross notional loan size or the \$800,000 loan size net of PMI protection. RMA can see rationale for both approaches. On the one hand, the probability of default for a \$900,000 loan with \$100,000 of PMI coverage is probably higher than the probability of default for an uninsured \$800,000 loan on the same property, as the borrower has less equity in the former case and will thus default more quickly as property values decline. However, the loss-given-default experienced by the bank on the \$900,000 loan will be lower than that for the \$800,000 loan, because when default occurs in the former case the first \$100,000 in losses are covered by PMI funds. Overall, RMA suggests that the exposure amount <u>net</u> of PMI more accurately represents the banks' economic exposure and should be used as the basis for risk-weight calculations.

Regarding the treatment of pool-level PMI, we appreciate the practical difficulties in assigning this protection to specific assets, but this protection can still play an important role in managing the risk of a mortgage portfolio. We encourage the Agencies to find an appropriate means of including pool-level PMI protection in Pillar One capital charges (perhaps as a securitization exposure with "negative" risk-weight) or, at a minimum, emphasize its risk-mitigating properties in Pillar Two.

Question 13: The agencies seek comment on the pros and cons associated with the two alternatives for calculating the LTV ratio (option 1 requires separate LTV calculations

for the funded and unfunded portions of loans secured by single-family homes, while option 2 combines funded and unfunded portions into a single exposure).

RMA is largely indifferent between the two methods but notes that the alternative provides somewhat greater opportunity for regulatory arbitrage. Under the alternative approach, in which the unfunded portion changes the risk-weight of the entire exposure, banks will be incented to shed any unfunded commitments that drag the entire exposure from one risk-weight bucket into a higher bucket. The proposed approach circumvents this problem.

We also note that, for practical purposes, the alternative approach is no "simpler" than the proposed approach. The difficulty of these measures lies in the gathering and management of data on the funded and unfunded exposures, not in the algebra required of the final calculation. As the alternative approach requires data identical to the proposed approach, the two are equally difficult to execute.

Question 14: The agencies seek industry views on any other risk-sensitive methods that could be used to segment residential mortgage exposures by risk level and solicit comment on how such alternatives might be applied.

As noted in our response to Question 1, FICO or other consumer credit scores might be employed to further segment residential mortgage exposures into various risk buckets. This might be particularly useful for portfolios that are targeted to either low-risk or high-risk population segments. We warn, however, that maintaining FICO scores (which should be regularly updated) can be burdensome for smaller institutions.

Question 15: The agencies seek comment on whether, for those banking organizations that are required to maintain specific provisions, it would be appropriate to follow the New Accord treatment, that is, the risk weight would vary depending on the amount of specific provisions the banking organization has recorded.

RMA strongly suggests that the Agencies adopt the provision as expressed in the international Accord. The practice of establishing impairment reserves on specific assets seems more prevalent than suggested in the NPR, but no matter how common, those institutions that recognize immediate earnings and capital impairment should be relieved of future capital requirements on that same asset. Conceptually, it seems clear that the immediate recognition of future losses reduces unexpected loss, so institutions need hold less capital against the asset.

Question 16: The agencies seek comment on whether these Zero H approaches should be included in the standardized framework. Additionally, the agencies seek comment on whether the Zero H approaches would adequately address the credit risk of repo-style transactions that would qualify for those approaches.

Regulators should be very careful about imposing an excessive regulatory burden on a repo market that serves important balance sheet management purposes. Smaller banks

must have open access to these markets in order to mobilize available cash and generate income on par with larger institutions. The conditions anticipated in the international Accord to qualify for Zero H seem appropriately conservative to merit a zero haircut or, alternatively, a zero risk-weight in the Standardized approach. Supervisors should be granted the authority to impose more burdensome risk-management techniques in cases where institutions are overly aggressive in these markets, but safe, simple, reasonable repo programs should be assessed with simple, reasonable measures such as the Zero H approach.

Question 17: The agencies request comment on the appropriateness of including the internal models methodology for calculating exposure amounts for OTC derivatives, eligible margin loans, and repo-style transactions in any final rule implementing the standardized framework. The agencies also requested comment on the extent to which banking organizations contemplating implementing the standardized framework believe they can meet the associated advanced modeling and systems requirements. (For purposes of reviewing the internal models methodology in the advanced approaches final rule, commenters should substitute the term "exposure amount" for the term "exposure at default" and "EAD" each time these terms appear in the advanced approaches final rule.)

RMA sees no reason why institutions with the ability to satisfy the compliance requirements for the internal model methodology should not be permitted to deploy this approach.

Question 18: The agencies solicit comment on the decision not to include internal risk ratings for ABCP programs, program ratings, and computer program ratings in this proposal.

RMA sees no reason why existing, risk-sensitive approaches to risk-weighting these exposures should be discontinued.

Question 19: The agencies solicit comment on this proposed treatment of operational risk, and, in particular, on the appropriateness of the proposed average positive gross income calculation.

The proposed treatment of operational risk requires significant modification, as detailed here. All of these comments should be considered in the context of the serious limitations in the proposed approach. We are unaware of any studies that demonstrate a link between gross income and operational risk, and one can just as easily argue that less profitable banks should be levied a higher operational risk capital charge than their more profitable counterparts. We realize that the BIS and the Agencies are faced with a significant challenge in finding simple proxies for the complex phenomenon of operational risk. Given this challenge, we hope the Agencies are amenable to the suggestions that follow.

1. The international Accord provides for three distinct Standardized operational risk calculation methods – Basic Indicator Approach (BIA), Standardized Approach (SA), and Alternative Standard Approach (ASA) -- yet the Agencies propose to permit only the BIA in the U.S. We feel this is mistaken for a number of reasons
   a. The SA is not particularly difficult to implement but provides a more risk-sensitive assessment than the excessively crude BIA
   b. The ASA is a critically important option given a specific flaw in the BIA formula. Because the BIA is calculated as a percentage of gross income prior to credit loss recognition, banks with high-margin but high-loss balance sheets face a particularly onerous operational risk capital charge. Credit cards, for example, demonstrate high expected loss and are priced accordingly. They seem to have no greater operational exposure than a mortgage lender that markets to the same customers, but their BIA capital charge can be many times higher. The problem is exacerbated when higher credit risk capital charges are taken into account. A commercial lender with a high-yielding but low-rated portfolio will hold higher capital both under the credit charge as well as the operational risk charge. This is precisely why the international Accord provides for the ASA in cases where "this approach provides an improved basis by, for example, avoiding double counting of risks."

   We caution that one unintended consequence of permitting only the BIA is that banks with high-loss, high-margin portfolios will choose not to comply with Basel II. These seem to be precisely the institutions that would most benefit from the heightened risk management requirements of the rule. The Agencies should follow the International Accord in this regard, and permit use of both the SA and ASA.

2. RMA is unaware of any compelling argument that suggests one dollar of earnings is evidence of very low operational risk, while one dollar of losses is not. The arbitrary exclusion of negative gross income observations in calculating a three-year weighted average should be eliminated. As noted above, we have no great affinity for the gross income proxy, but if the Agencies choose to ride this measure, they should do so whether the value is positive or negative.

3. The Agencies should clarify the calculation of trailing three-year gross income for organizations that are rapidly growing either organically or through acquisition. As written, it would appear that active acquirers, for whom trailing gross income was generated by a smaller entity, actually face a *lower* operational risk capital charge than stable banks of a similar size. This is clearly a problem, as operational risks are greatest in the midst of integration and rapid growth. Conversely, banks that sell businesses should not carry the operational risk capital contributed by that business for a full three years. Examiners should be given the discretion to discount the contribution of historical gross income when it inaccurately represents the current entity

4. BIA provides no capital incentive for banks to reduce actual operational risks. The only way for a bank to reduce its operational risk capital charge is to make less money – hardly a useful incentive. Valuable risk mitigation tools such as third-party insurance play no role in the BIA operational risk calculation. Lacking an ability to integrate such features into the Pillar One capital charge, we encourage regulators to emphasize insurance and other mitigants in Pillar Two.

5. Prompt Corrective Action has the curious effect of inflating the operational risk capital charge by 25% for U.S. banks. The mechanical derivation of operational risk capital starts by calculating a capital requirement, which is then converted into a risk-weight by multiplying by 12.5 (the inverse of the international 8% minimum capital requirement). But the re-conversion of this risk-weight back into a capital requirement is done at the de facto 10% minimum for well-capitalized status under PCA. As such, U.S. banks really need to hold 25% more capital against operational risk than is suggested by the BIA formula. Ideally, the Agencies would unwind this discrepancy by reducing the BIA multiple, but at a minimum regulators should be keenly aware that the operational risk capital charge for U.S. institutions is inflated.

In sum, RMA strongly suggests that the Agencies make available all three international methods for calculating operational risk capital. We also strongly suggest that the BIA calculation include all three years of trailing gross income, even if negative. Finally, RMA strongly encourages regulators to consider actual operational risk characteristics, beyond the crude proxies of income and assets, in their Pillar Two assessments of risk and capital need.

Question 20: The agencies therefore solicit comment on the appropriateness of including the AMA for calculating the risk-based capital requirement for operational risk in any final rule implementing the standardized framework and the extent to which banking organizations implementing the standardized approach believe they can meet the associated advanced modeling and systems requirements.

The AMA is a vastly superior means of assessing bank operational risk capital requirements. RMA strongly encourages the Agencies to allow banks, at their discretion, to use AMA for operational risk capital calculations under Standardized Basel II. It is not clear how many institutions are currently equipped to comply with AMA, but we expect that most would require additional systems and data development. Regulators should embrace these investments in stronger risk measurement and management systems if banks are willing to pursue them.

Question 21: The agencies seek commenters' views on all of the elements of the proposed public disclosure requirements. In particular, the agencies seek comment on the extent to which the proposed disclosures balance providing market participants with sufficient information to appropriately assess the risk profile and capital strength of individual institutions, fostering comparability across banking organizations, and minimizing burden on the banking organizations that are reporting the information. The agencies

further request comment on whether certain banking organizations (for example, those not publicly listed or not required to have audited financial statements) should be exempt or have more limited disclosure requirements and, if so, how to preserve competitive equity with banking organizations required to make a full set of disclosures.

The proposed disclosures are, for the most part, both reasonable and appropriate given the aims of Pillar Three. Among the measures that some banks might find burdensome are:

1. Managing the data needed to track geographic composition, counterparty industry, and counterparty type
2. Decomposing past-due, non-accrual, allowances, and charge-offs by counterparty industry and type
3. Accounting for collateral type in various OTC and repo positions
4. Comprehensive and detailed calculation of all financial collateral
5. Comprehensive measures of NII sensitivity and/or equity duration for the banking book

The following disclosure requirements might also be perceived as proprietary

1. Geographic, counterparty industry, and counterparty type information
2. Descriptions of collateral management policies
3. Key assumptions used in the valuation of equity positions
4. Loan and non-maturity deposit pre-payment assumptions

IV. Additional Observations

This section contains additional observations that either clarify points made earlier or emphasize features of the NPR not raised in the formal questions.

1. RMA suggests that the Agencies demonstrate caution when straying from the International Accord. The Agencies were prudent in staying mostly faithful to the International Accord, and in the case of residential mortgage LTV risk-weight buckets, their modification improved risk sensitivity and the overall rule. But there are a few areas in which the Agencies departed from the International Accord with less certain results:
    a. The prohibition of SA and ASA operational risk measures
    b. The absence of distinct SME lending risk-weights
    c. Treatment of exposures with specific reserves
    d. Zero H haircuts
    e. And, of, course, the application of Prompt Corrective Action and the Leverage Ratio

    The U.S. Agencies certainly had a strong voice at the BIS, and elements of the International Accord that survived U.S. objection must have sound backing in the eyes of the international regulatory community. We suggest that the U.S. Agencies consider the merits of continued adherence to the international Accord as they move to finalize the rule.

2. The Agencies should clarify their philosophy on whether Pillar One intends to risk-weight *assets* or *institutions*. One could argue that Pillar One is really about assets, and that the focus should be on the inherent riskiness of exposures rather than an institution's ability to manage the exposure. Pillar Two should then consider institutional risk and capital management capabilities, making adjustments for sophistication and experience.

   As structured, the U.S. framework is at odds with this philosophy because the same asset receives vastly different risk-weights at different institutions, depending upon which of the four capital regimes (General, Standardized, Advanced, un-regulated) it belongs to. Is it really sensible that a particular mortgage or C&I loan has one level of implied risk at a small S&L and a different level of risk at a large multi-national? If the answer is "no", then the Agencies should strive to make risk-weights as similar as possible across regimes. They should also avoid a conservative bias in establishing Standardized and General risk-weights. The (purportedly) superior risk management abilities of Advanced banks should then be accounted for in Pillar Two.

3. The Agencies should also clarify a number of technical issues:
   a. Definition of legal entity materiality, as noted in our response to Question Two.
   b. Definition of portfolio materiality for Pillar One risk-weighting
   c. Definition of "conditionally uncancellable" for assets such as HELOC's
   d. Whether loan-level PMI reduces the notional exposure only for the purposes of LTV calculation, or does it also decrease the size of the exposure that is risk-weighted (see our response to Question 12 for additional detail)

4. On balance, RMA does not perceive the NPR to be excessively complex or burdensome. Some aspects of the rules for securitization, derivatives, and collateral are certainly quite complex, but in all cases simpler alternatives are made available.

5. The Agencies should closely monitor the regulatory arbitrage opportunities created by disparate Pillar One risk weights in the various capital regimes. Differing regulatory capital requirements might ultimately drive differences in perceived economic value and competitiveness in certain product sets.

Appendix

Institutions in the RMA Capital Working Group

Staff participating in the preparation or review of this paper: