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By E-mail and Overnight Courier

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Re: Response to proposed changes to the framework of the internal ratings based approach for credit risk described in the Basel Committee's October 11, 2003 Press Release

Ladies and Gentlemen:

On October 11, 2003, the Basel Committee on Banking Supervision (the "Committee") issued a press release identifying proposed changes to the framework of the internal ratings based approach for credit risk requesting comment by December 31, 2003 (the

"Proposal"). Subsequent to the Committee's press release, the U.S. regulatory agencies[1] issued a statement and the European Commission issued a consultation note, each of which was consistent with the Proposal. This letter is MBNA America Bank, N.A.'s response to each of those requests for comment.[2]

In its release, the Committee provided only a general statement on the proposed changes to the treatment of expected losses. Neither the U.S. Agencies nor the European Commission provided any additional information regarding the proposed change. We believe it would improve the overall development effort of the New Basel Capital Accord (the "New Accord" or "Basel II") for the Committee, and the appropriate supervisory authorities, to provide additional information regarding the proposed changes and their intended application. We also understand the Committee is reviewing the capital requirements for unsecured retail loans and we encourage the development of a solution that better reflects the underlying economic risks for those products and lowers their capital requirements. Although we support the Proposal in general, our evaluation and commentary is limited by the lack of overall information provided with respect to the proposed change.

We firmly agree that it is inappropriate to assign capital for expected losses and commend the Committee for its decision to limit the specific capital formulas to unexpected losses only. Nevertheless, the Proposal is still not based on the economic realities of the banking business model, particularly unsecured retail lending, and therefore, does not yet present a workable solution. The Proposal correctly eliminates the expected loss component from the capital formulas, but incorrectly adds a new capital deduction based on expected losses. We believe that the simple rearrangement of terms without impacting the overall capital requirements when compared to Consultative Paper 3 ("CP 3") is not an appropriate solution.

In fact, the Proposal actually increases capital requirements for qualifying revolving exposures ("QREs"), an asset class, which we believe is already over-burdened with unduly conservative capital requirements.[3] Under CP 3, QREs are required: (a) to hold capital for unexpected losses, plus 25% of expected losses, and (b) general reserves were included as a component of capital. By eliminating expected losses from the capital formula, the Proposal only lowers QRE capital requirements by 25% of expected losses

1 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's (together the "U.S. Agencies")

2 MBNA America Bank, N.A. is the principal subsidiary of MBNA Corporation and has two additional banking subsidiaries, MBNA Europe Bank Limited and MBNA Canada Bank (collectively herein referred to as "MBNA"). MBNA's primary business is unsecured retail lending, providing credit cards and other retail lending products to individuals.

3 Please see MBNA's response letters to both CP 3 and the U.S. ANPR for a more complete discussion of issues related to QRE exposures.

because of the existing limitation within the QRE formula. At the same time, the Proposal completely eliminates reserves as a component of capital. The result of this change is an increased capital requirement for QREs. The Committee, the U.S. Agencies, and the European Commission must be prepared to move beyond simple changes to terms and formulas and instead construct a framework that is more firmly rooted in economic capital theory.

When determining regulatory capital requirements, the Committee should not ignore the pricing practices and the benefits of future margin income ("FMI"), as currently implied by the Proposal. Expected losses are a normal cost of doing business. Margins on loan products, particularly unsecured retail loans, are set to cover operating costs and expected losses, plus provide a favorable return on capital. In addition, banks have the ability to re-price revolving retail exposures in those circumstances where credit losses increase beyond expected levels and thereby maintain their return on capital. Including expected losses as part of regulatory capital requirements, either as specified in the CP 3 formulas or deducted directly from capital as presented in the Proposal, ignores the most fundamental elements of retail lending pricing practices.

The lack of differentiation in the treatment of FMI between both retail and corporate loans, and secured and unsecured retail loans, is particularly onerous to unsecured retail lenders whose products: (a) are priced to cover higher, though more predictable, expected losses when compared to corporate loans (the average expected losses in a portfolio of retail loans is typically larger than that of corporate loans), and (b) do not benefit from the more favorable loss given default parameter of secured lending (which looks to the value of the collateral for repayment in the event of default). Without the benefit of FMI, unsecured retail lenders will be required to hold disproportionately higher capital levels than the risk exposures would otherwise demand. This creates an inequitable capital requirement, the very issue the QRE sub-category in CP 3 was designed to address.

Our experience, based on an analysis of our U.S. credit card securitization data over the past 60 months, demonstrates that the average portfolio FMI (in this case defined as net interest income, less a servicing fee) is almost two times the mean gross charge-off rate. This FMI calculation does not yet include any benefit from other "non-interest" fees such as interchange income and is also exclusive of any recoveries from charged-off loans, which would further increase loss coverage by FMI. Our analysis also shows that there exists a very low standard deviation to mean charge-offs, thereby demonstrating the very high predictability of credit card loss rates.

CP 3 correctly recognized the significant benefits of FMI for QREs. We are very concerned that the loss of FMI credit for QREs as contemplated by the Proposal, will ignore the unique attributes of revolving retail loans and their ability to fully cover expected losses. To be clear, we are not requesting that FM1 be used as an offset for unexpected losses. We believe, however, that the Proposal incorrectly eliminated the risk mitigation benefits of FMI and that FMI should be given full consideration as an offset to expected losses in the final accord.

We also disagree with the requirement that when expected losses are greater than the established loss reserve those losses must be taken from capital. Such an approach conflicts with both generally accepted accounting principles in the U.S. ("U.S. GAAP")[4] and U.S. regulatory policy.[5]

For unsecured retail lending, particularly revolving lending, it is not uncommon for a loss reserve to be less than one year. This is because for many retail loans the average life of the outstanding balance is less than one year. By establishing a specific time frame in which to calculate expected losses, the Committee has created a fundamental disconnect between the concept of expected losses for U.S. GAAP purposes versus that for Basel II regulatory capital purposes. We can see no logical reason why the definition of expected losses under regulatory capital guidance should be different from that under U.S. GAAP. The adoption of such a change will represent a fundamental shift in current U.S. regulatory guidance on loan loss allowances for unsecured retail lending. Moreover, the adoption of this approach in Basel II will put it at odds with allowance guidance issued by the International Accounting Standards Board, which also requires the use of an "incurred loss" model.

The elimination of loss reserves and the inclusion of new adjustments to regulatory capital to reflect excesses or shortfalls between loan loss reserves and expected losses included in the Proposal, also implies a change in the definition of regulatory capital. To correctly introduce a true "unexpected losses only" framework requires that the definition of capital conform to the economic realities of unsecured retail lending. Reserves should continue to be included as capital since expected losses are fully covered by FMI.

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[4] The guidance for establishing a reserve for loan losses is addressed in U.S. GAAP under FASB Statement No. 5 and 114. Under U.S. GAAP a loss must be recognized when it is probable that such a loss has been incurred and the amount of the loss can be reasonably estimated. While this targets expected losses only, U.S. GAAP limits recognition of expected losses to those inherent in the asset balance as of the balance sheet date. This is known as an "incurred loss" model: loss recognition is appropriate only to the extent to which it is probable that the loss has been incurred as of the balance sheet date. This approach conflicts with any model that is limited to a specific time period of future losses - such as one which encompasses losses that are expected to be recognized over the subsequent twelve-month period - because such a model would include losses on loans which have not yet been made.

[5] In 1995 and 1996, the U.S. Agencies adopted interagency guidelines establishing standards for safety and soundness, pursuant to Section 39 of the Federal Deposit Insurance Act. Those guidelines instruct institutions to conduct periodic asset quality reviews to identify problem assets, to estimate the inherent losses in those assets and to establish reserves that are sufficient to absorb estimated losses. The interagency policy statement issued July 6, 2001, in concert with the SEC's issuance of Staff Accounting Bulletin No. 102 clarifies that for financial reporting purposes, including regulatory reporting, the loan loss reserves must be determined in accordance with U.S. GAAP. Moreover, in the *Comptroller's Handbook,* the 0CC, specifically notes that the "[c]overage periods of less than one year are usually associated with pools of consumer installment or credit card loans, where the OCC's classification policies require charge off at 120 days and 180 days respectively." *Comptroller's Handbook,* "Allowance for Loan and Lease Losses," at p. 14 (June 1996). Absent unusual circumstances, "most banks should be able to demonstrate that something less than 12 months coverage is adequate for such pools." Id.

In the event that the Committee chooses to ignore the economic realities of unsecured retail lending and decides to exclude loss reserves from capital with adjustments for shortfalls or excesses, we would recommend that any shortfall be treated as a supervisory deduction. This would be similar to the current U.S. treatment of the capital charge for retained interests in a securtitization, rather than a direct reduction of either Tier 1 or Tier 2 capital. This will allow the shortfall to be captured in the capital ratios without directly reducing the Tier 1 or Tier 2 capital levels. Without any further guidance on the intentions of the Committee other than the October 1 1th press release, we are very concerned about the possible repercussion of this charge on the calculation of other components of capital and their limits (e.g., goodwill and other intangibles) if the shortfall were deducted directly. We do not believe that banks should be penalized this way.

We appreciate the opportunity to provide these comments. If you have any questions regarding this submission or if we can provide further information, please contact Vernon Wright directly by telephone at 302-453-2074 or by e-mail at vernon.wright@mbna.com.

Yours truly,

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