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Financial Guardian Group

900 Seventeenth Street, N.W., Suite 506
Washington, D.C. 20006
Phone: (202) 296-5240
Fax: (202) 452-6816

Karen Shaw Petrou
Executive Director

Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219
Attention: Roger Tufts

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Attention: Jason Cave

Board of Governors of
the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Attention: Barbara Bouchard

Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Attention: Fred Phillips-Patrick

Dear Sir or Madam:

The Financial Guardian Group is pleased hereby to respond to the agencies' request for views on the treatment of expected versus unexpected loss in the Basel risk-based capital rules, as well as in the implementation of them proposed for the United States in the agencies' advance notice of proposed rulemaking (ANPR). [68 Fed Reg 45,900] The Financial Guardian Group (FGG) represents banks deeply concerned that the proposed new Pillar 1 capital charge for operational risk will have serious safety-and-soundness and competitiveness problems. As a result, we support Pillar 2 treatment for operational risk-based capital (ORBC) and were pleased to provide the agencies with a Pillar 2 approach in our comment on the ANPR.

The FGG is surprised that the Basel Committee and the U.S. regulators have requested comment on the expected loss (EL)/unexpected loss (UL) issue only in connection with credit risk. In our view, the concerns expressed by advocates of UL treatment for credit risk apply equally with regard to operational risk (OR). As with credit risk, EL resulting from operational risk is commonly addressed through practices such as reserving and budgeting, and should be excluded from any capital adequacy calculation. However, in sharp contrast to credit risk, there are no accepted models, measurements or historical data on UL in operational risk, and, as U.S. regulators have noted in the past, the separation of UL from EL under a Pillar 1 approach raises significant accounting challenges for U.S. banks. As a result, the separation of UL from EL for operational risk under a New Basel Accord should be accompanied by a shift in the treatment of operational risk from the proposed Pillar 1 capital requirement to a Pillar 2 supervisory regime.

Credit Risk EL Rationale Applies to Operational Risk

As noted above, the FGG is surprised that the agencies' request for comment applies only to the internal ratings-based (IRB) models proposed for credit risk. Although the request does not detail this rationale, the many comment letters that have argued for exclusion of EL in the Pillar 1 regulatory capital charge for credit risk focus on the fact that EL is already addressed through reserves, future margin income (FMI) and pricing. Indeed, even as currently proposed, the IRB for credit risk excludes some EL because of the favorable treatment of credit risk mitigation (CRM). By permitting CRM to offset regulatory capital, regulatory capital excludes EL addressed through risk mitigation. Indeed, the agencies and the Basel Committee are now proposing to improve the treatment of CRM to reflect the low probability of a double default by both a borrower and CRM provider. This would rightly focus regulatory capital principally on UL.

There are, of course, numerous challenges to recognizing only UL for credit risk-based capital – most notably with regard to how reserves can be adjusted to reflect U.S. accounting concerns and international competitive ones. Leaving these "how to" questions aside, however, it is clear that insurance, reserves, pricing, FMI and risk mitigation are a more appropriate way to ensure that banks have an ample cushion in place to handle expected loss. It is fundamentally the business of banks to understand expected loss and to manage it, with pricing set to anticipate EL and reserves, CRM and future margin income in place to absorb it. If EL is addressed in capital even as banks hold reserves against it, price for it and handle it through FMI, then this risk is double-counted and regulatory capital would diverge from economic capital — a direct contradiction to the major goal of Basel II to more closely align regulatory and economic capital for banks. In its numerous comment letters to Basel and the U.S. agencies, the FGG has repeatedly argued that EL in operational risk is best addressed through reserves, budgeting, insurance and other proven forms of risk mitigation. Many other comment letters have echoed this concern, and the AMA attempts to reflect them through very limited recognition of these factors.[1] However, these limits result in precisely the same double-counting problem addressed through the proposed exclusion of EL for credit risk. Again, the result of counting EL in any assessment of a bank's capital adequacy — whether under Pillar 1 or Pillar 2 — would be a significant discrepancy between regulatory and economic capital.

EL in Operational Risk

A look at several of the factors underlying operational risk makes clear why EL should be excluded from Pillar 1 regulatory capital. As proposed in the ANPR and Basel's third consultative paper (CP3), OR includes such factors as external and internal fraud, systems failures and legal risk. However, EL in all of these is well understood and mitigated. Banks are often able to cover the losses associated with these risks simply through their earnings, with absolutely no threat to solvency. Banks also bear the cost of fraud and similar acts through earnings, pricing, and budgeting, as well as through insurance, and the compensating protection is well understood in advance and appropriately accounted

[1] See ANPR comment letters filed by: Bank of America, Bank One, Citibank, J.P. Morgan Chase, Northern Trust, Synovus, and Wachovia. The above letters are in addition to ones specifically calling for both expected and unexpected operational losses to be accounted for in Pillar 2. See comment letters from America's Community Bankers, FleetBoston Financial, State Street, SunTrust, MBNA, Mellon Financial, Merrill Lynch, U.S. Bancorp, Washington Mutual, World Savings and Zions Bancorp among others.

for. In the case of litigation, U.S. banks are required to establish significant reserves to offset potential penalties. Similarly, even natural or other disasters are covered by insurance – a proven form of risk mitigation as demonstrated in the Basel Committee's Risk Management Group's most recent OR loss data collection exercise.[2] Thus, EL is well-handled through various techniques and is handled without threat to solvency. As with credit risk, EL for operational risk thus should be excluded from the proposed Pillar 1 capital calculation.

Problems with Operational Risk UL

Operational EL can and should be addressed outside the Pillar 1 capital regime. However, addressing UL for operational risk under Pillar 1 is especially problematic — in sharp contrast to credit risk, where regulatory capital for UL is generally accepted.

As has often been acknowledged by U.S. regulators, techniques for the modeling of operational risk, and the resulting calculation of an appropriate level of regulatory capital, are far less advanced and reliable than those for credit risk. While the challenges to accurately modeling operational risk apply to both EL and UL, they are particularly relevant in relation to UL. For example, the variability of loss distribution curves generated by operational risk modeling is most significant for the type of potential severe "tail" loss events the regulators hope to capture in the operational risk proposal, and which would be the focus of a UL-only regime. Unlike EL, predictions for UL cannot be validated from subsequent internal loss experience, since the underlying assumption of a 99.9% confidence level and a one-year holding period stipulated in the ANPR suggests that UL is a one in 1,000 year event. In addition, the two elements of the AMA calculation intended to reflect the possibility of low frequency, high severity events which would likely be considered UL — the use of external data and scenario analysis — remain extremely troublesome. The use of external data and scenario analysis are extremely subjective elements, more suited to use in a qualitative risk analysis, rather than more quantitative modeling. A UL-only capital requirement will heighten reliance on these uncertain and subjective factors in a regulatory capital requirement.

In addition, as the U.S. regulators have noted in the ANPR and related Draft Supervisory Guidance, there are significant challenges to recognizing legitimate EL offsets under U.S. accounting rules. Since no such accounting issues are present for non-U.S. institutions, the result of shifting to a UL-only approach for a Pillar 1 capital charge will increase the competitive disadvantage created under the proposal for U.S. banks.

As a result of these concerns, we urge the Basel Committee and U. S. regulators to accompany a change to UL-only capital treatment for operational risk with a shift in the overall treatment of operational risk from Pillar 1 to Pillar 2. Under Pillar 2, regulators can implement a full — but flexible — evaluation of capital adequacy, taking into account the nascent state of operational risk measurement methodologies, without the negative competitive impacts of an inflexible Pillar 1 capital requirement.

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[2] *The 2002 Loss Data Collection Exercise for Operational Risk: Summary of Data Collected,* Bank for International Settlements, Basel Committee, March 2003.

Conclusion

The FGG supports the proposed focus of the Basel capital rules on UL, and we strongly recommend that similar treatment be extended to operational risk, whether operational risk is ultimately regulated under Pillar 1 or Pillar 2. This is essential to avoid the same type of regulatory double-counting of concern in credit risk related to reserves, as well as the proven role of pricing, budgeting and risk mitigation in operational risk. Such a change, however, makes it even more critical that operational risk be addressed through Pillar 2, rather than the proposed Pillar 1 capital requirement. A Pillar 2 treatment of operational risk, with an evaluation of capital adequacy based on UL, will provide a flexible regulatory framework for the effective management and mitigation of operational risk by U.S. banks.

We would be pleased to provide additional data to support these points and assist the agencies in any way requested to help in the development of the type of effective Pillar 2 operational risk-based capital charge discussed in the ANPR comment.

Sincerely,

Karen Shaw Petrou
Executive Director

Cc:
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland