From: "Rich Whiting" <rich@fsround.org> on 12/31/2003 02:00:15 PM

Subject: New Basel Capital Accord II

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December 31, 2003

Communications Division
Public Information Room, Mailstop 1-5
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219
Attention: Docket No. 03-14

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Attn: Docket No. 2003-27

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551
Docket No. R-1154

Robert E. Feldman
Executive Secretary
Attention: Comments/OES
Federal Deposit Insurance
Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Proposed Treatment of Expected Losses and Unexpected Losses Under the New Basel Capital Accord

Dear Sirs or Madams:

The Financial Services Roundtable ("Roundtable") represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic engine accounting directly for $18.3 trillion in managed assets, $678 billion in revenue, and 2.1 million jobs. The Roundtable appreciates the opportunity to provide these additional comments to the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), and

the Office of Thrift Supervision ("OTS") (collectively, "the agencies") on the proposed treatment of Expected Losses ("EL") and Unexpected Losses ("UL") under the proposed new Basel Capital Accord ("Basel II" or the "New Accord") and its implementation in the United States.

Introduction

As we have stated in previous comment letters, the Roundtable supports the goal of revising the existing capital adequacy requirements for internationally active banks. We agree with the overall objectives of the New Accord, which include creating a better alignment of regulatory capital to underlying economic risks, promoting better risk management, and fostering international consistency in regulatory standards.

On October 11, 2003, the Basel Committee on Banking Supervision ("Committee") proposed separating the treatment of Unexpected Losses and Expected Losses within the IRB approach. Under this proposed new approach, the measurement of risk-weighted assets would be based solely on Unexpected Losses. Offsets for future margin income would be removed from IRB calculations as no longer necessary. Banks would be required to compare the IRB measurement of Expected Losses with the total amount of provisions made for losses, including both general and specific reserves. If the amount of EL is greater than the total provisions, the amount of this "shortfall" would be deducted from total capital: 50 percent from Tier 1 capital and 50 percent from Tier 2 capital. Excess provisions or reserves are proposed to be included in Tier 2 capital, subject to limitation at supervisory discretion and, in any case, not to exceed 20 percent of Tier 2 capital.

The agencies have requested additional comments on this proposal and how it would impact the New Accord. The Roundtable appreciates the opportunity to provide input on this important issue and offers the following recommendations.

The Roundtable Supports Separating Expected Losses and Unexpected Losses within the IRB Approach

We agree with the Committee that separate treatment for EL and UL would lead to a superior capital framework. The Roundtable strongly supports removing EL from IRB capital calculations and capital charges. Expected Losses are already taken into account by banks in pricing loans and other products and in determining appropriate levels for loan loss reserves. Any capital charge that includes EL would have the effect of double counting such losses. The Roundtable welcomes the Committee's proposal to remove EL from IRB risk-weight calculations. However, a full evaluation of these changes can not be made until the Agencies provide a more detailed proposal, including a specific definition of EL and any proposed re-calibration of the IRB calculations.

We recommend that the New Accord and U.S. implementing measures clarify that capital charges also should not be imposed on Expected Losses in the case of capital calculations for the trading book or for operational risk. Risks from Expected Losses are factored into reserves and pricing for all types of products and services and exposures, not solely those in the banking book, as well as in implementing systems to manage predictable operational risk. While

Roundtable members do not all agree on whether, or what form of, capital charges are appropriate for operational risk under Basel II, our members are in broad agreement that any operational risk capital requirement should exclude Expected Losses.

The Roundtable Opposes an EL Cap in Regulatory Capital

While the Roundtable strongly supports including "excess" loan loss and other reserves (i.e., amounts exceeding EL calculated by the bank) in regulatory capital, we do not agree with the proposal to limit the amount of such excess reserves that are includible in Tier 2 capital. The 20 percent cap is an arbitrary, unjustified limit.

It is not clear if the Committee's proposal to adjust regulatory capital to reflect excesses or shortfalls in loan loss reserves compared to Expected Losses under the IRB approach implies a change in the definition of regulatory capital for all purposes (*e.g.,* prompt corrective action, leverage ratios, lending and investment limits, *etc*.). If not, the effect of this would be to require Basel II banks to maintain on their books at least two different calculations of "Tier 1" capital – a potentially confusing and burdensome result. On the other hand, the broader implications of having different definitions of Tier 1 and Tier 2 capital for Basel II banks than for non-Basel II banks – or for U.S. banks that must follow the Advanced IRB Approach under Basel II *versus* banks in other countries that permit the Standardized Approach – should be considered. The Roundtable suggests that this issue could benefit from the collection of data in connection with the agencies next Quantitative Impact Study before the New Accord or U.S. implementation rules are finalized.

Finally, Roundtable member companies believe that it will take considerable effort to conform the proposed new capital regimes to U.S. accounting principles and requirements. The concepts underlying the Agencies' proposal, including UL and "excess" provisions, are not recognized under GAAP accounting, creating uncertainty about the coordination between regulatory capital calculations and financial reporting.

Conclusion

The Roundtable and its member companies appreciate your consideration of the Roundtable's views on these important issues. We applaud your responsiveness to the concerns of the industry as the Basel II process continues.

The Roundtable re-iterates that because of the complexity of these issues, the Committee and the agencies should provide adequate phase-in time in the implementing timetable of the New Accord, so that there will be minimum negative impact on the financial services industry and the U.S. economy.

If you have any further questions or comments on this matter, please do not hesitate to contact me or John Beccia at (202) 289-4322.

Sincerely,

Richard M. Whiting
Executive Director and General Counsel