Bank of America

December 30,2003

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

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

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

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

Regulation Comments
Chief Counsel's Office, Office of Thrift Supervision
Attention: No. 2003-27
1700 G Street, NW
Washington, DC 20552

Re: Proposed Treatment of Expected and Unexpected Losses

Dear Messrs. and Mmes.:

Bank of America would like to thank the Basel Committee for its October 11,2003 consultation document on the Proposed Treatment of Expected and Unexpected Losses (proposed treatment) and the opportunity to participate in this consultation. Bank of America, with $737 billion in total assets, is the sole shareholder of Bank of America, N.A., with full-service consumer and commercial operations in 21 states and the District of Columbia. Bank of America provides banking and investing services, corporate and investment banking, and financial products and services to individuals and businesses across the United States of America and around the world.

The Committee's proposal is another significant advance toward a true risk-sensitive capital framework With the proposed elimination of expected losses (EL) from the internal ratings-based capital requirement, the framework for the measurement of risk is now more closely aligned with that employed by large institutions and with the best practices of the industry We agree with the Committee's view that this is a superior and more appropriate approach for determining the amount of *required* capital

Unfortunately, the proposed treatment also includes offsetting changes in the determination of *actual* capital and fails to address several longstanding issues regarding regulatory capital definitions and limitations on qualifying capital We believe these issues warrant consideration and further modification before final implementation

General Issues

Our response to CP3 commented on several points concerning the specific calculations that measure a bank's possible losses, including the treatments of expected loss, credit hedging, correlation and maturity We considered the treatment of expected loss to be a fundamental flaw in CP3 Our reasons for this stance focused on the relationship between EL and future margin income (FMI) We noted that, as banks consider EL to be a cost of doing business and set product margins to both compensate for EL and earn a favorable return on capital, EL should be removed from the capital requirement This framework would adopt the best practice of the industry

Although the recent proposal to remove EL from the capital requirement does indeed reduce the divergence between the industry and regulatory measures of risk, our point concerning the relationship of EL and FMI still applies The proposal notes that with the removal of expected loss from the capital requirement, "certain offsets . . . in particular future margin income, would no longer be necessary." We consider this misleading, as the two treatments of EL – as a component of the risk measure or a deduction from actual capital – are ultimately equivalent

We strongly recommend the adoption of the industry approach, which recognizes that product margins are set so that FMI will compensate for EL and therefore neither adds EL to the capital requirement nor deducts it from capital If the Committee prefers to retain an explicit treatment of EL, this can best be accomplished either by restricting the EL deducted from reserves to that of noii-performing loans or by allowing explicit estimates of FMI to offset EL, subject to an appropriately conservative haircut

In addition, we propose the Committee discard the notion of caps or restrictions on the amount of resources that may be considered as capital In particular, there should be no limit on the amount of reserves that qualify as capital, as the full amount of reserves is available to cover losses Failing this, any restrictions or limits should not depend on the particular capital structure of the bank, i.e. the allocation between Tiers 1 and 2

Expected Loss and Available Resources

A risk-based capital adequacy framework should match the measured risk to the financial resources available to cover that risk. The financial resources available to cover expected and unexpected loss over a given horizon include common equity (CE), loan loss reserves (LLR), and future margin income (FMI) generated during the period. This comparison of losses to resources is labeled Economic Approach A in the following table, which compares the economic, industry, and regulatory approaches to evaluating capital adequacy. Two alternative but equivalent approaches based only on UL are provided. The first approach, Economic Approach B, counts the excess of reserves over EL as a component of capital but also recognizes the gross amount of FMI as a resource. The second approach, Economic Alternative C, counts total reserves as capital but recognizes the expected profit margin rather than the full amount of FMI as an available resource. The obvious equivalence of these two alternatives clarifies the seemingly contradictory industry remarks that both pricing and reserves cover expected loss.

Approach	*Risk Measure*	*Available Resources*
Economic Approach A	EL + UL	CE + LLR + FMI
Economic Approach B	UL	CE + (LLR – EL) + FMI
Economic Approach C	UL	CE + LLR + (FMI – EL)
Industry Approach	UL	CE + LLR
Regulatory Approach (CP3)	EL + UL	CE + LLR + FMI Card*
Regulatory Approach (Oct 11)	UL	CE + (LLR – EL)**

* *The regulatory approach limits recognition of LLR to 1.25% of risk-weighted assets in Tier 2 capital. It provides limited recognition of FMI for credit card (i.e., 0% or 75% of credit card EL)*
** *The proposed treatment allows LLR – EL to account for up to 20% of Tier 2 capital.*

The industry approach to measuring risk is firmly based on unexpected loss. To determine capital adequacy, the capital requirement for unexpected loss is generally compared to common equity and the full amount of LLR. This approach implicitly recognizes the risk-mitigating benefit of FMI as it assumes that FMI is at least sufficient to cover EL. Since it does not include the profit margin embedded in loan pricing as a financial resource, the industry approach is conservative relative to the pure economic cases.

With the elimination of EL from the capital charge, the best approach for regulatory capital would allow banlcs to recognize the full amount of LLR as capital If EL is to be deducted from reserves, FMI must also be incorporated to completely account for the financial resources available to buffer loss However, the explicit calculation of FMI and its integration into the capital calculations would clearly increase the complexity of the approach An alternative, which may be more appealing to the Committee, would retain an EL deduction from reserves but limit the deduction to non-performing (i.e., defaulted) assets The FMI on performing assets would be assumed to cover the expected loss instead of being explicitly calculated

Noting this distinction between performing and non-performing assets, we would also point out that neither CP3 nor the proposed treatment compute unexpected loss for defaulted assets Our internal approach estimates a UL for defaulted assets to account for uncertainty in the recovery stream and assigns capital accordingly In light of the change to include only the UL component of the capital requirement in the regulatory framework, the Committee should reconsider the treatment of capital for defaulted assets

Explicit Treatment of FMI and EL

If the Committee wishes to retain an explicit treatment of EL, then the recognition of FMI on the performing portfolio is required to avoid understating the available financial resources We firmly believe that the best solution is to simply recognize all reserves However, appreciating that the Committee may not be comfortable with eliminating the EL deduction on the basis of an *assumed relationship* between EL and FMI, we provide the following discussion of an *explicit treatment*.

Before proceeding, we reiterate our view that the comparison of EL to FMI should be made for all exposures regardless of product type As we noted in our response to CP3, tlie circumstances for qualifying retail portfolios are not unique Margins on all products are available to buffer expected loss

We understand the Committee's primary concern is that the value of FMI may be insufficient in the 99 9% credit scenario to offset EL We believe this concern is unwarranted for two reasons First, the costs of foregone income are already included as an economic loss in the LGD estimates for each product Therefore, the gross amount of FMI before all economic losses from credit risk is relevant Second, late fees, grid pricing and other structural mitigants create a stabilizing effect on revenue when credit conditions deteriorate These points suggest that any difference between FMI in the 99 9% scenario and the unconditional expected value of FMI is likely to be modest

Rather than cap or eliminate the recognition of FMI, tlie framework should explicitly measure the FMI and apply a haircut to account for modest deterioration in the 99 9% credit scenario The framework should allow this adjusted FMI to offset up to the full amount of EL Applying haircuts to FMI would ensure a conservative calculation yet also accommodate partial recognition and eliminate the need for separate threshold tests

The following formulas provide a more concrete description of the proposed approach:

$$Excess(Shortfall) = LLR - Max(0, EL - FMI^{*})$$

$$FMI^{*} = Haircut \times E(FMI)$$

The size of the haircut should reflect the historical relationship of FMI and loss for the product. If this adjusted FMI were expected to exceed EL in the 99.9% credit scenario, there would be no deduction of EL from reserves. While the above approach would add additional complexity to the framework and require supervisory validation, the estimation and validation process for FMI is not inherently more difficult than for PDs and LGDs. Nevertheless, given the need to recognize the relationship of FMI and EL and the complexity of any explicit approach, our strong preference is to avoid explicit treatment of FMI in favor of full recognition of loan loss reserves with no deductions from capital for EL.

Tier 2 Designation of Reserves and Limited Recognition

We strongly believe there should be no limitation on the amount of reserves that qualifies as capital. Nor should reserves be viewed as a form of secondary capital. Reserves cover losses even before shareholders equity and therefore should be counted as Tier 1 rather than Tier 2 capital. Moreover, loan loss reserves are simply an accounting reclassification of common equity to a contra asset account. This reclassification has no effect on the solvency of the institution, yet the artificial subdivision of capital into Tier 1 and Tier 2 categories makes it appear that institutions in regulatory jurisdictions with more conservative reserving practices are less solvent than comparable institutions in other countries.

The significant differences in reserving practices across regulatory jurisdictions would have no impact on reported capital ratios if common equity and loan loss reserves were placed on equal footing within Tier 1 capital. Banks in the United States are particularly disadvantaged since they tend to have much higher loan loss reserves than banks in other jurisdictions. It is paradoxical that conservative reserving practices would be penalized in a risk-based capital framework.

In addition, the proposed treatment continues to include arbitrary limits on the total amount of reserves qualifying as capital. Under the Basel I framework the amount of reserves allowable as Tier 2 capital was limited to 1.25% of risk-weighted assets. Under the current proposal, this limit is replaced with a cap at 20% of Tier 2 capital. Neither of these limitations is justifiable, as all of the loan loss reserve is available to absorb loss. In fact, the proposal's limit is a step backwards and is more restrictive than the original CP3 framework for institutions whose Tier 2 capital is comprised of significant reserves and relatively little subordinated debt. In the extreme case, banks with little subordinated debt in their capital structure would not be able to recognize the benefit of loan loss reserves at all.

Summary

We recommend that the capital framework compare a capital requirement based solely on unexpected loss with the available resources of common equity and the entire amount of loan loss reserves. This would align the regulatory framework with the best practice of the industry and reduce the complexity of the regulations. If the Committee prefers to retain an explicit treatment of EL, it should recognize all available financial resources and include future margin income as an offset to the EL deduction from capital. A haircut of FMI would be sufficient to ensure the adequacy of resources to cover total EL. If explicit recognition of FMI is deemed too complex for implementation, an alternative, which deducts only the EL of non-performing assets, should be given serious consideration.

We strongly urge the Committee to consider accounting for loan loss reserves as a component of Tier 1 rather than Tier 2 capital. Such a treatment would go a long way toward evening out the distorting effects of differences in reserving and accounting practices across jurisdictions. In addition, we urge the Committee to reassess the need to constrain the amount of reserves qualifying as capital and, at a minimum, the structure of the limit in the current proposal.

We would like once again to thank the Committee for its continued dialogue with the industry. We would be happy to discuss our views in greater detail, or to discuss any new ideas that the regulatory authorities wish to pursue. In that regard, please contact me at (415) 953-0243 or Randy Shearer, our Senior Vice President and Director of Accounting Policy, at (704) 388-8433.

Sincerely,

John S. Walter
Senior Vice President
Risk Capital & Portfolio Analysis