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Capital One Financial Corporation
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November 3, 2003

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1154
regs.comments@federalreserve.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention 2003-27
regs.comments@ots.treas.gov

Re: Implementation of New Basel Capital Accord – Advance Notice of Proposed Rulemaking - Comments of Capital One Financial Corporation

Ladies and Gentlemen:

Thank you very much for providing us the opportunity to comment on the Advance Notice of Proposed Rulemaking issued for public comment by the four federal banking agencies (the "Agencies") with respect to the proposed new Basel Capital Accord ("ANPR"). Capital One Financial Corporation, McLean, Virginia (together, with all of its subsidiaries, "Capital One") is a holding company whose principal subsidiaries offer consumer lending and deposit products, including credit cards, installment loans, automotive loans and mortgages.

Capital One had 46.4 million customers and $67.3 billion in managed loans outstanding, as of September 30, 2003. A Fortune 200 company, Capital One is one of the largest providers of MasterCard and Visa credit cards in the world. Capital One also offers automotive financing through its Capital One Auto Finance business. In addition, Capital One expects that it will be one of the world's largest issuers of asset-backed securities in 2003.

Capital One offers consumer credit products in Europe through its bank subsidiary Capital One Bank (Europe) plc ("COBEP"). COBEP had over 3 million customers and £2.9 billion in managed loans outstanding as of September 30, 2003, and is one of the fastest growing issuers of credit cards in the United Kingdom.

General Concerns

As a global issuer of credit cards and a large issuer of asset-backed securities, Capital One is particularly concerned about the potentially disparate impact of the proposed new Accord on credit-card lenders. While we applaud the Agencies' proposal to apply the new Accord only to the largest and most internationally active financial institutions in the United States, we are concerned about the new Accord's potential impacts on our European bank, COBEP. As discussed in additional detail below, we also oppose the proposed regulatory capital requirement for undrawn lines of credit in credit-card portfolios.

As a result, we urge the Agencies to continue to influence the Basel Committee's rulemaking process with respect to issues such as credit-card commitments, securitization, and expected losses. In that regard, we note the Basel Committee's announcement on October 11, 2003 that it will revisit its treatment of credit-card portfolios. We encourage the Agencies to reflect the Basel Committee's changes in their subsequent rulemaking, as appropriate. We also encourage the Agencies to amend the ANPR to remove expected losses from the proposed regulatory capital requirements, adopting the approach contemplated by the Basel Committee in this regard.

Retail Lending: EAD Calculation for On- and Off-Balance Sheet Assets in QRE Portfolios

Capital One opposes the imposition of a regulatory capital requirement on undrawn lines of credit related to credit-card assets. As the Basel Committee revisits several elements of the proposed Accord, including QRE portfolios, Capital One would like to comment in detail on the proposed approach to undrawn lines of credit for on- and off-balance sheet credit-card assets. The ANPR takes the position that financial institutions must consider the likelihood of additional drawings on the unused portion of a credit card line when the bank determines its loss estimates. Under the Advanced IRB approaches, the bank must incorporate those risk assessments into the bank's calculation of EAD or LGD. We believe that this requirement could lead to a significant and unwarranted increase in the amount of capital that banks must hold against credit card accounts. As such, we strongly oppose this provision as we believe that it does not accurately reflect the true risk exposure faced by institutions engaged in this type of consumer lending.

The requirements proposed in the ANPR should not require regulatory capital to be held against these assets because banks have very broad discretion to cancel these commitments. Because lenders will only permit future draws when appropriate capital funding is available, we believe that up-front capitalization with respect to undrawn lines of credit is unnecessary. As additional draws on credit-card loans are booked onto the balance sheet, the lender must increase capital in an amount sufficient to preserve the correct capital ratio. If at any point additional capital becomes unavailable, the lender will immediately withdraw open lines. Future draws on open-to-buy are contingent on adequate future capital access. As such, there is no need to set aside capital in anticipation of future exposure. For commitments, such as credit-card assets, that banks have broad discretion to cancel, *capital at default* will always be adequate for *exposure at default* if capital is accumulated as the draws are booked.

Viewed another way, there is no meaningful distinction for regulatory capital purposes between an existing account expected to draw and a new account expected to book: lenders permit neither exposure in the absence of proper funding; however, the requirements proposed by the ANPR would require banks to hold upfront capital in the case of the former. The ANPR does not require that capital be held against planned future growth, because it correctly presumes that a bank will not pursue planned future growth if it cannot be properly funded, and we believe that this reasoning should also apply to undrawn lines of credit for credit-card assets. New accounts are booked only if conditions permit, and if fresh capital is added at the time of booking. Capital will be added as draws are booked; if additional capital is unavailable, open to buy will be withdrawn. We also note that the ANPR would not require upfront regulatory capital for undrawn balances relating to corporate loans that a bank may cancel, and we believe that the Agencies should apply the same treatment to undrawn lines of credit on credit-card accounts.

While sophisticated credit management has helped reduce the typical amount drawn prior to default, EAD still exceeds 100 percent. And while lenders must properly capitalize these drawn amounts, there is no compelling reason to capitalize them prior to booking. Banks' broad discretion to cancel (or reduce) these accounts ensures that either the capital will be available at the time of booking, or the draws will not be booked. The ANPR already recognizes that the discretion to cancel an account is a critical determinant of capital needs. For example, the ANPR suggests that the Credit Conversion Factor for securitized uncommitted retail lines should range from 0% to 40%, depending upon excess spread, while the Credit Conversion Factor for committed retail lines is always 90%, regardless of spread. This distinction presumably acknowledges the more manageable exposure of lines that banks have broad discretion to cancel, a feature that is also relevant for the calculation of on-balance sheet capitalization needs. Furthermore, as noted above, the ANPR also indicates that the Credit Conversion Factor for certain uncommitted corporate facilities is 0%, versus 75% for committed facilities. We believe this logic should be extended to uncommitted retail facilities, particularly QREs.

In accordance with requests made to industry by the Basel Committee and the Agencies for quantitative responses to the Third Consultative Paper ("CP3") and the ANPR, Capital One would like to address the proposed capital charge for undrawn lines of credit in significant detail. Please see Appendix A to this letter for a more detailed summary of our position.

Additional Data Studies Needed

For the reasons stated in our letter to the Basel Committee responding to CP3, we also urge the Agencies to conduct additional data studies to gauge the impact of the requirement proposed by the ANPR and the proposed Accord itself. We have attached a copy of our letter to the Basel Committee as Appendix A. We have also submitted that letter to the European Commission. Specifically, we have urged the Basel Committee to conduct a fourth Quantitative Impact Study to examine several issues, including whether that capital curve for QRE portfolios is appropriately calibrated. Capital One generally supports the Agencies' efforts to create more risk-sensitive regulatory capital rules and hopes the Agencies will thoroughly consider the impact of their proposed regulatory capital requirements on all lending portfolios. We applaud recent indications by the Agencies and the Basel Committee that they may pursue such data studies in some manner.

* * *

In closing, we thank you again for allowing us the opportunity to comment on the ANPR as the Agencies continue to develop a more risk-sensitive Basel Capital Accord. We appreciate the consideration given to our comments, and we look forward to further opportunities to participate in this process.

Respectfully submitted,

/s/ Andres L. Navarrete

Andres L. Navarrete
Associate General Counsel
Capital One Financial Corporation

APPENDIX A

Capital One

Capital One Financial Corporation
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July 31, 2003

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Bank for International Settlements
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CH-4022
Basel, Switzerland
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Re: Basel Capital Accord Consultative Paper 3 – Comments of Capital One Financial Corporation

Ladies and Gentlemen:

Thank you very much for providing us the opportunity to comment on the most recent package of consultative papers proposing revisions to the Basel Capital Accord ("CP3"). Capital One Financial Corporation, McLean, Virginia (together, with all of its subsidiaries, "Capital One") is a holding company whose principal subsidiaries, Capital One Bank, Glen Allen, Virginia and Capital One, F.S.B., McLean, Virginia, offer consumer lending and deposit products, including credit cards, installment loans, and mortgages. Capital One offers consumer credit products in Europe and other regions outside the United States, including through its bank subsidiary Capital One Bank (Europe) plc. Capital One also offers automotive financing through its Capital One Auto Finance business.

Capital One had 45.8 million customers and $60.7 billion in managed loans outstanding, as of June 30, 2003. A Fortune 200 company, Capital One is one of the largest providers of MasterCard and Visa credit cards in the world. Capital One also expects that it will be one of the world's largest issuers of asset-backed securities in 2003.

As a global issuer of credit cards and a large issuer of asset-backed securities, Capital One is particularly concerned about CP3's potentially disparate impact on credit-card lenders. We have two conceptual concerns in this regard: (1) the A-IRB approaches to retail portfolios, especially those containing Qualifying Revolving Exposures ("QREs"), are less developed than the A-IRB approaches for wholesale portfolios; and (2) the disparate capital impact on credit card portfolios versus mortgage portfolios predicted by the third Quantitative Impact Survey ("QIS 3") must be further analyzed to determine if the risk profiles of those portfolios support such disparate treatment.

As discussed in more detail below, credit card lenders are particularly disadvantaged by CP3 as currently drafted, a result we believe to be inconsistent with CP3's goal of capital neutrality across asset classes. While the ultimate Accord should produce higher regulatory capital requirements for lending and other activities that generate greater risk, and lower regulatory capital requirements for lending and other activities that generate less risk, CP3's approach to QREs does not accurately reflect the risks created by credit card lending.

We therefore urge the Committee to conduct a fourth Quantitative Impact Study to examine these issues, including whether that capital curve for QRE portfolios is appropriately calibrated. Supporting this request, at least one United States banking agency has called for additional quantitative studies before the Committee finalizes the Accord. In testimony before the United States Congress in June 2003, Comptroller of the Currency John D. Hawke indicated that a fourth Quantitative Impact Study will probably be needed to calibrate the impacts created by CP3, particularly as the Committee fine-tunes the Accord over time. We agree that additional investigation of several matters is necessary, and we support significant additional study before the Committee finalizes the Accord. Capital One generally supports the Committee's efforts to create more risk-sensitive regulatory capital rules and hopes the Committee will thoroughly consider the impact of CP3 on all lending portfolios.

Capital One would like to make the following additional comments:

Retail Lending: General Comments

Capital One believes that the Committee needs to further develop the Accord's approach to credit card portfolios with respect to both process and substance. While the Committee and the US banking agencies have requested quantitative feedback on the impact of the proposed capital requirements with respect to retail portfolios, guidance in this regard has not been sufficiently clear for us to provide the Committee or our regulators with mutually useful data. The results of QIS 3 suggest that other banks have also struggled to provide meaningful data that would allow the Committee to achieve its objectives. Following the release of more definitive guidance, Capital One would be pleased to provide more specific, quantitative analysis that demonstrates the impact of the A-IRB approaches applicable to retail portfolios.

Furthermore, based on the unclear assumptions that the Committee has provided thus far, retail lenders have forecasted capital requirements that contradict the Committee's goal of capital neutrality. QIS 3 predicts that regulatory capital required for QRE portfolios will increase by 16% beyond the regulatory capital required by the current risk-based capital rules, while regulatory capital required for mortgage and other retail portfolios could decrease substantially, by 56% and 25%, respectively. As stated above, we agree that a more risk-sensitive approach to regulatory capital will necessarily lead to different regulatory capital requirements for some portfolios. However, the Committee has not provided any data to support these significant variances in capital treatment for credit card portfolios, and as a result, we believe the Committee must perform significant additional data analysis to validate these results. If the Committee cannot provide data showing a need for additional regulatory capital with respect to QRE portfolios, the Committee should pursue methods of stabilizing the Accord's impact on those portfolios. We make specific suggestions in that regard below.

Retail Lending: QRE Credit Risk Curve

Despite significant work by the US banking agencies and retail lenders, we believe that the capital curves for QRE exposures proposed by CP3 remain inappropriately calibrated. The current proposal would penalize credit card lenders without establishing a basis for doing so. Based on the data accumulated thus far, unsecured retail lenders will be severely damaged by the new Accord, and the economies that depend on consumer lending could be significantly damaged as a result. In some circumstances, the additional capital required to operate these business lines could be the marginal cost that drives certain consumer lenders out of business. Capital One is concerned that the uniform application of complex mathematical models, for which most elements appear to have been developed independently, will produce overall results that do not correspond to the associated credit risk and which undermine the Committee's stated goal of capital neutrality across asset classes.

-- *The Committee Should Thoroughly Reexamine the A-IRB Approach to QRE Portfolios.*

We request the Committee to conduct a thorough reexamination of the assumptions underlying the QRE credit risk curve before finalizing the Accord. As stated above, Capital One is concerned about both the Committee's process regarding QRE portfolios and the substantive results being generated for those portfolios by CP3's assumptions and mathematical models. It remains difficult for QRE lenders to fully and accurately respond to the calibration of the QRE capital curve when the underlying data and the methods which were used in its calibration remain unclear. For instance, the Committee has not provided analytical support for the Committee's reduction of the FMI offset from 90% to 75% following comments on the second Consultative Paper.

Capital One also believes that the current assumptions and mathematical models for QRE portfolios will produce results that substantially harm both the competitive position of credit card lenders and their ability to continue certain lines of business. Specifically, the QRE curve could require retail lenders to hold regulatory capital against lower-risk assets that do not properly reflect the credit risk presented by those assets. In particular, the asset correlations for low-PD loans are exceedingly high, and the QRE curve remains relatively flat for high-PD loans. Banks would respond to that incentive by holding excessive capital for low-risk loans, potentially leading lenders to prefer to hold riskier assets in their portfolios. This preference would lead to a competitive advantage for financial institutions that generate subprime loans and apply the proposed asset correlations to those loans, if examiners do not hold individual banks to a higher standard than the minimum requirement pursuant to the supervisory oversight required by Pillar Two.

-- *The Committee Should Permit a 100% Offset of FMI Against Expected Losses.*

We urge the Committee to mitigate the impact of the proposed capital requirements for QRE portfolios by permitting QRE lenders to use 100% of future margin income ("FMI") to offset expected losses generated by QRE portfolios. Because it is a common industry practice to price QRE loans to cover expected loss, the proposed 75% offset does not fully reflect the risk mitigation that FMI provides for these portfolios. In addition, unlike mortgages or commercial loans, revolving loans have the ability to change terms and conditions throughout the life of the loan as well as revoking the loan commitment. Therefore, if expected loss changes throughout the life of the loan, FMI will change accordingly.

Also supporting this proposal, particularly in the United States, fee and finance charge reserves mitigate concerns about the collectibility of revenue generated by QRE exposures. In January 2003, the Federal Financial Institutions Examination Council ("FFIEC") in the United States released guidance requiring credit card lenders to hold reserves against the collection of fees and finance charges (the "FFIEC Guidance"). While some institutions, including Capital One, have had such reserves in place for a number of years, the FFIEC Guidance contains the first published regulatory recognition that such reserves are necessary to protect against credit losses in credit card portfolios. These reserves mitigate the collection risk that may have caused the Committee to lower the FMI offset to 75%. Fee and finance charge reserves are deducted from accrued revenue and therefore have a direct, negative impact on a credit card lender's FMI. In light of the preceding arguments, we urge the Committee to allow QRE lenders to offset 100% of FMI against expected losses.[1]

In summary, Capital One requests that the Committee conduct a fourth Quantitative Impact Study before the Accord is finalized. We also urge the Committee to (1) conduct a thorough reexamination of the assumptions underlying the QRE credit risk curve before finalizing the Accord and (2) permit a 100% offset of FMI against expected losses for QRE portfolios.

Asset-Backed Securitization

Capital One believes that the Committee's current approaches to retained positions and early amortization features are sufficient to protect against the risks posed by these assets and structures. The asset-backed securitization market and its

[1] If the Committee does not accept this approach, we believe the Committee should treat fee and finance charge reserves in a manner similar to Allowances for Loan and Lease Losses ("ALLLs"), which CP3 allows institutions to offset against expected losses in certain circumstances.

participating financial institutions would benefit from stabilized rulemaking in this regard. While the securitization market has been the focus of several regulatory concerns in recent years, in part due to the abuses of special-purpose entities by a small number of companies in other contexts, we believe that recent rulemaking has largely addressed those specific concerns. We are concerned that broader rulemaking in this regard could affect securitization structures that do not present risks that were not previously apparent. We appreciate the Committee's measured approaches to retained positions held by originators and to facilities supported by early amortization features.

Home/Host Country Issues

We believe that the Accord should follow the US approach to consolidated groups which contain banks that are chartered in different countries. We support the recent comments of Federal Reserve Vice Chairman Roger Ferguson indicating that a bank's home country should govern whether the financial institution complies with the new Accord.

Basel compliance by a non-US subsidiary should not force US banks in the same consolidated group to comply with the Accord on a non-voluntary basis. For example, Capital One Bank is chartered in the United States and owns a bank subsidiary that is chartered in the United Kingdom. Based on the Advanced Notice of Proposed Rulemaking issued in the United States, the US implementation approach would require the non-US bank subsidiary to comply with the Accord, while the US parent bank would not have to comply with the Accord. We support this approach to Basel compliance and encourage the Committee to ratify this approach in the final Accord.

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In closing, we thank you again for allowing us the opportunity to comment on the Committee's third Consultative Paper as it continues to develop a more risk-sensitive Basel Capital Accord. We appreciate the consideration given to our comments, and we look forward to further opportunities to participate in this process.

Respectfully submitted,

/s/ Frank R. Borchert

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