Financial Guardian Group

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Karen Shaw Petrou
Executive Director

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Mr. Roger Cole
Deputy Associate Director
Board of Governors
Federal Reserve System
20th and Constitution Avenue
Washington, DC 20551

Dear Roger:

Thanks again for organizing the meeting between Fed and OCC staff and the Financial Guardian Group (FGG) on March 5. We appreciate very much your willingness to meet with us, your willingness to consider the FGG's views, and the many changes made to the operational risk-based capital (ORBC) proposal since 2001 in response. We are also grateful for the interest in a special approach to credit risk for banks like those in the FGG. We are, however, disappointed that it appears the proposal provided on operational risk disclosures in a Pillar 2 environment will not receive further attention. The FGG believes such an approach will enhance operational risk management under Basel 2, and provide full "comparability" between institutions.

In this note (which I recognize you may wish to place in the public record), I would like to reiterate the FGG's continued concern with the negative competitive impacts of a Pillar 1 approach to operational risk, and address an issue we did not highlight at our meeting: the need to adopt an unexpected loss (UL) only approach to operational risk.
Following are some additional thoughts:

1. Competitiveness

The FGG remains very concerned by the competitive impact of the proposed treatment of operational risk. I shall write shortly to Ed Ettin in greater detail regarding his suggestion that the pending SEC consolidated supervised entity (CSE) proposal addresses these concerns. In general, however, we are not persuaded that the CSE proposal will result in comparable capital requirements for institutions availing themselves of the CSE option. In addition, regardless of the specific treatment of operational risk under the proposal, the CSE structure will be optional, and limited to a very small subset of FGG members' non-bank competitors.

While we appreciate efforts by the Federal Reserve to research various competitive impacts, it should be recognized that the two competition studies released to date do not address the key competitive concerns of the FGG. The SME study, of course, focuses on areas unrelated to FGG members' business lines, as will future studies related to residential mortgages and credit cards.

The study related to mergers and acquisitions may have some bearing on the relative competitiveness of U.S. banks as evidenced by M&A activity, but it does not address competition with either non-banks or non-US banks. Overall, the study is somewhat inclusive. However, as the authors suggest, there may be signs that regulatory capital is a factor in mergers and acquisitions – that is, that capital matters.

2. Special U.S. Concerns

As briefly discussed during our meeting, the advanced measurement approach (AMA) is a significant improvement over the initial ORBC proposals. The FGG, however, continues to believe that the concepts underlying the AMA would be most effective if implemented in a Pillar 2, rather than a Pillar 1, context. We have commented extensively on definition, measurement and related concerns about the AMA, and we would be pleased to continue these discussions. However, here I would like to note several specific U.S. problems:

- Imposition of the unique U.S. leverage and prompt corrective action standards requires banks to hold significant amounts of regulatory capital above economic amounts to ensure that they remain "well capitalized" for regulatory and market purposes. As a result, U.S. banks are effectively subject to higher capital requirements than overseas competitors.

- As Mike Bleier stated at the meeting, the benchmarking of business lines required within the AMA, as proposed, would compel reporting along standardized lines that do not comport with those on which FGG banks manage their operations and report to the SEC under GAAP. Maintaining two reporting and data systems – one for bank management and the SEC and the other just to permit regulators to benchmark the AMA against standardized business lines – would be extremely disruptive and costly.

3. EL/UL Issues

As you well know, the Basel Committee has decided on a major revamping of the proposed rules to cover only UL in credit risk. The FGG believes this concept should be extended to operational risk as well. As our numerous comment letters – and many others – have noted, expected operational losses, like credit losses, are borne through earnings, reserves and loss mitigation in a well-understood and reliable fashion. Like credit risk, any assessment of capital adequacy for operational risk – whether under Pillar 1 or Pillar 2 – should focus on unexpected losses, not expected losses.

However, addressing UL for operational risk under Pillar 1 is especially problematic, in contrast to credit risk, where such methodology is clearly stipulated. As we noted in previous comments, the challenges to modeling operational risk are significant. Forecasts for UL usually cannot be validated from subsequent loss experience, and two critical aspects of the AMA's treatment of UL – use of external data and scenario analysis – are highly subjective, and not well suited for use in a Pillar 1 regulatory capital calculation. In addition, as U.S. regulators have noted in the past, there are significant challenges to recognizing legitimate EL offsets under U.S. accounting rules. These issues can only be resolved by shifting the treatment of operational risk from Pillar 1 to Pillar 2.

In short, we believe that the best use of all the hard work done in the development of the AMA is to incorporate it into a meaningful Pillar 2 supervisory approach, backed by the type of strong disclosure regime suggested in our recent letter. We would be pleased to discuss this further with you and your colleagues, and appreciate all the attention paid so far to our views.

Sincerely,

Karen

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