



1801 Market Street, Suite 300, Philadelphia, PA 19103

MAURICE H. HARTIGAN II
President & CEO

215-446-4001 • Fax 215-446-4008
E-mail:
mhartigan@rmahq.org

March 26, 2007

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
ATTN: Docket No. 06-09

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve
System
20th Street and Constitution Avenue, NW
Washington, DC 20551
ATTN: Docket No. R-1261

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

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2006-49

**Re: Risk-Based Capital Standards: Advanced Capital Adequacy Framework
Modifications**

Ladies and gentlemen:

The Risk Management Association (RMA)¹ is pleased to comment on the Notice of Proposed Rulemaking (NPR) issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the Agencies) that proposes a new Advanced Capital Adequacy Framework. As the Agencies are aware, RMA has been actively involved in the effort to reform the regulatory capital guidelines for the past decade and fully supports a more risk-sensitive alignment of regulatory capital standards. Exposures that have higher risk should require more capital; and conversely, lower-risk exposures should require less capital. Clearly, in an appropriately risk-sensitive capital regime, capital will either be higher or lower based on risk.

¹ Founded in 1914, RMA is a not-for-profit, member-driven professional association whose sole purpose is to advance the use of sound risk practices in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, and operational risk. RMA's membership consists of more than 3,000 financial services providers and 18,000 risk management professionals who are chapter members in financial centers throughout North America, Europe, and Asia/Pacific.

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RMA is very concerned that the Agencies seem to have abandoned this most fundamental concept of the 2004 Framework – that capital levels should be commensurate with risk. Indeed, RMA is quite dismayed by the extent to which the Agencies have diverged from the 2004 Framework. Our concern is only compounded by the continued delay of the Basel II implementation process in the U.S., which has increased costs for the industry, and created the potential for competitive inequities to arise between U.S. and foreign Basel II-Advanced compliant firms. Additionally, not permitting all U.S. banks the same options available to banks in the other Basel countries is inequitable for community banks – indeed, banks of all sizes – in the U.S. Further, the continued divergence of the U.S. from the 2004 Framework will dramatically increase the implementation burden and cost for all banks, without a commensurate improvement in prudential standards.

In our response to the ANPR more than three years ago, RMA expressed great concern that the prescriptiveness of the U.S. approach to implementing Basel II could have a chilling effect on continued industry innovation. These concerns have only grown, and in some respects exponentially, with the release of the NPR.

In the response that we submit today, we have outlined these concerns in considerable detail. We believe that the only way to move forward at this point in time requires the full adoption of the 2004 Framework – that is, allowing the full availability to all U.S. institutions of the options the Framework provides (Standardized, Foundation IRB, and Advanced IRB).

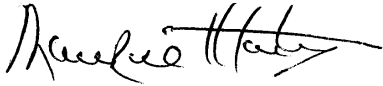
U.S. divergence from many of the fundamental principles of the 2004 Framework at this late stage in the Basel II implementation is problematic in many respects. Certainly the addition of the 10 percent aggregate floor, three-year phase in period, and the modified definition of default for wholesale exposures comprise our most pressing concerns. Other significant concerns include the U.S. addition of the ELGD versus LGD concept, and the use of the Supervisory Mapping Function, and the different treatment of some equity investments. RMA is also concerned that the U.S. has eliminated the 2004 Framework's treatment of loans to small-to-medium business enterprises (SME).

While RMA certainly understands that the Agencies have a prudential role to ensure an adequate level of capital within the U.S. banking system, we believe that it is important for the Agencies to recognize the 2004 Framework provides additional safeguards in Pillar 2 (Enhanced Supervision) and Pillar 3 (Market Disclosure) to prevent unsafe and unsound declines in regulatory capital levels. Moreover, the U.S. Agencies have long had the authority to require individual banks to raise capital, and can and do issue supervisory guidance to require additional capital for certain underwriting practices. And, the U.S. also continues to retain the Minimum Leverage Ratio – which we believe could have the unintended effect of increasing risk within the banking system.

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RMA has attempted to provide as much detail as possible in our response to the NPR and with our answers to the 62 questions it contains. We have also answered questions 19 through 22 in the Basel IA proposal that pertain to Basel II institutions, and we have responded to the IA NPR by separate cover as well. It is our hope that the Agencies will find our input useful and we stand ready to be of any further assistance that you may deem appropriate. Please feel free to contact me at 215-446-4001 or via email at mhartigan@rmahq.org, or Pam Martin, our Director of Regulatory Relations, at 215-446-4092 or via e-mail at pmartin@rmahq.org

Sincerely yours,

A handwritten signature in black ink, appearing to read "Michael H. Harty". The signature is fluid and cursive, with a long horizontal stroke at the end.

Attachment

**Response to the U.S. Notice of Proposed Rulemaking
Regarding the Basel II Capital Regulations**

**Risk Management Association
Capital Working Group**

March 26, 2007

I. Introduction and Overview

The RMA Capital Working Group² is pleased to present this response to the September 25, 2006 publication of the Notice of Proposed Rulemaking (“NPR”) dealing with the U.S. banking agencies’ implementation of the Basel II Advanced Internal-Ratings Based (“AIRB”) capital standards. Our Group remains a staunch supporter of the move toward best-practice, models-based, truly risk-sensitive, minimum capital requirements. As such, we believe that the standards published by the Basel Committee in June, 2004 (the “Framework”) represent an important step toward a dramatic improvement in the ability of regulators to assess the safety and soundness of financial institutions in world markets.

The Basel II countries outside the U.S. have introduced the Framework’s standards already, and many of the world’s largest banks already have begun a “parallel reporting” period in which they are calculating capital requirements both under the current Basel I standards and the new Basel II standards. In the U.S., as noted in the February 2007 GAO Report, “The banking regulators have differing regulatory perspectives, which has made reaching consensus on the proposed rule difficult.” Such a lack of consensus inevitably has led to delays.” Indeed, some stakeholders in the process already have submitted responses to the U.S. NPR without having benefit of seeing new draft “supervisory guidance” that provides necessary details on how the new U.S. standards are to be implemented. Since it takes considerable time and effort to develop a Group consensus on many of these important issues, the reader of this response should note that our Group has not yet fully digested the new supervisory guidance (for which the comment period ends May 29, 2007). We expect to provide additional comments on the new guidance on or before the deadline for such comments.

The delay in the U.S. implementation of the Framework has been a tremendous burden on those U.S. banks most likely to be subject to the new rules. At a minimum, the time between finalization of the U.S. rules and any individual bank receiving qualification from its supervisor(s) to embark on a parallel reporting period has been narrowed. Further, the delays have made it difficult to budget appropriately for necessary changes in the manner in which the institution calculates risk parameters, deals with risk data, etc. As a result, U.S. banks will face higher compliance costs than banks in other countries, no matter the exact nature of the final U.S. rules.

Compliance costs associated with implementation delays, while important, may be, however, the least of our worries. In this response we express concerns over other extremely important issues, including 1) the competitive equity between, on the one

² The Risk Management Association (RMA) is the leading professional association dedicated to the measurement and management of risk in banking and finance. The RMA Capital Working Group consists of senior officers at the leading banking institutions in the U.S. and Canada who are responsible for the measurement of risk and the determination of economic capital. Individual banks that are members of the Capital Working Group may have views that differ from those expressed in this paper and may be responding separately to the NPR. The names of the institutions and staff members contributing to this paper are provided in an Appendix.

hand, U.S. banks subject to the Basel II AIRB approach and, on the other hand, non-U.S. Basel II institutions, U.S. investment banks, and other, non-regulated financial companies; b) the burden of multinational banks in the U.S. and abroad of having to meet differential reporting requirements, along with the burdens of calculating two sets of Basel II capital requirements (the U.S. version of Basel II and the version being used by the rest of the Basel community); and c) the impact on the prudential objectives of regulators, and on the flow of funds to low risk activities, of the various U.S. capital “floors.”

In the sections that follow we discuss, first, the major differences between the U.S. Basel II proposals and the Framework employed in the other Basel countries. These differences have implications for each of the three major issues discussed immediately above. Next, we discuss some issues that the Basel Committee itself will need to deal with as the world’s banks respond to the sea-change in capital regulation. Finally, we provide responses to the 62 questions asked in the NPR. Note that the RMA AMA Group is responding under separate cover to the questions dealing with operational risk capital.

II. The Impact of Major Differences between the U.S. Proposal and the Basel II Rules Currently in Use in Other Basel Countries

A. The U.S. proposal does not permit banks to choose from among the 3 Basel II choices embraced by the Committee – Standardized, Foundation, and AIRB.

The insistence, so far, of the U.S. agencies that there will be only a single, permissible Basel II choice – the AIRB approach or the current U.S. capital standards (whatever they might be, since proposed revisions such as the IA proposal have not been finalized) – results in a clear competitive inequity for both “mandatory” and “opt-in” U.S. banks. Among both types of institution in the U.S. there are banks that are close to being constrained, or are constrained, by the U.S. leverage ratio requirements from expanding further into low-risk activities (see discussion below). For these banks, the very high compliance costs associated with becoming AIRB-compliant are not matched by any real reduction in their minimum regulatory capital requirements (as should be the case in individual circumstances where the bank’s portfolio of activities is less risky than that of other banks).

Indeed, it is our view that the AIRB approach should match closely the internal, best-practice economic capital process for the measurement of risk and the allocation of capital. But that is not the case. The RMA Capital Working Group has prepared more than 20 papers over the last 7 seven years that have detailed differences between the Framework and best-practice internal capital allocation procedures. The U.S. proposal makes matters worse by essentially requiring the U.S. mandatory multinational institutions to incur costs for 3 types of capital calculations – internal best practice, the U.S. regulatory approach, and the AIRB Framework used by the rest of the Basel countries. During the transition period a 4th capital approach – the old Basel I standard or whatever replaces it – is required. With no possible upside in the form of a reduction in the capital associated with truly low risk activities – because of

the leverage ratio floor and the other U.S. floors -- it is no wonder that many senior officers in large U.S. banks view Basel II in the U.S. as all cost and no benefit. To these institutions, Basel II is nothing more than an extremely costly compliance exercise.

At a minimum, if U.S. regulators do not eliminate the mandatory nature of the AIRB approach for certain very large U.S. banks, the choice of the 3 international standards should be given to all the other U.S. banks. To do otherwise would result in forgoing the systemic benefits, including the benefits in meeting general prudential objectives, of having a set of more risk-sensitive capital requirements in the U.S.

Additionally, given the built-in delays in U.S. implementation, and the very large uncertainties still remaining with regard to the specifics of U.S. implementation, the U.S. regulators should be flexible regarding the supervisory qualification process for mandatory AIRB banks. This flexibility should include the ability to use the Standardized approaches for parts of the portfolio during an agreed upon implementation schedule for the individual bank, including the use of the Basic Indicator and/or Standardized version of an operational risk capital charge during the implementation schedule.

B. Aggregate industry floor of 10% for the decline in capital requirements relative to the Basel I standard. Such a requirement does not exist in the non-U.S. version of Basel II.

1. The Basel II AIRB approach is intentionally risk-sensitive. Therefore, the risk-based regulatory capital minimums will be somewhat sensitive to the business cycle -- being low during the strong portions of the cycle, and vice versa. If the cycle-insensitive Basel I standard were deemed to be roughly "correct" on a through the cycle basis (an assertion that we do not believe is appropriate for most sophisticated, complex banks), then it is not unreasonable to have the Basel II standard result in more than a 10% decline in the minimum capital ratios during a boom period relative to the mid-point of the cycle. Note, however, that such a decline in the minimum capital requirements is not the same thing as a decline in the bank's *actual* level of capital -- which must be kept higher than the minimum requirements during booms, to protect against future downturns.
2. The 10% aggregate floor will work to dissuade U.S. banks from reducing the level of risk in their activities during the transitional period. That is, a reduction in risk clearly results in lower Basel II capital requirements, while, under the Basel I standard, the bank's capital requirements might not change at all. Banks will need to keep up their level of risk during the transition period to avoid triggering the 10% floor mechanism. Moreover, it might take only a few banks that decided to reallocate funds toward lower-risk activities during the transition period (to gain market share in these activities), to impose a penalty on all U.S. Basel II banks. The 10%

floor is a classic example of a well-intentioned rule working in a diametrically opposed direction to the aim of supervisory prudential standards.

3. Should the regulatory agencies believe that regulatory capital levels are too low under Basel II, then, under Pillar 2, the regulatory agencies have the clear authority to require additional capital. Thus, the 10% aggregate floor is unnecessary to maintain a prudential level of minimum capital requirements.

- C. The U.S. phase-in period will be longer than in the other countries (at least 3 years instead of 2 after the parallel reporting period) and may be longer than 3 years depending on the circumstances of the individual bank. The U.S. rule will also involve higher capital floors, relative to Basel I, during each of the transition periods.

As in the case of the aggregate floor, the U.S. phase-in floors could act to keep U.S. Basel II banks from increasing the flow of funds into lower risk activities, and this would occur for a longer period of time than for the Basel II banks in the rest of the world. This represents both a competitive equity issue and an inconsistency with meeting proper prudential objectives. See the discussion below on the U.S. minimum leverage ratio requirement.

- D. U.S. minimum leverage ratio requirement.

The U.S. minimum leverage ratio requirement, of course, exists even in the absence of Basel II. Some U.S. Basel II banks are already hampered by this existing rule (a *legislated* requirement that insured depository institutions must have a 5% Tier 1 to total assets ratio to be considered “well capitalized”) -- whenever the banks seek out additional low-risk activities. The leverage ratio requirement may cause banks to engage in costly securitization to remove low-risk loans from the books, or to seek out high-risk activities to “match” with the low-risk activities. Absent these strategies – often termed “regulatory capital arbitrage” -- the 5% minimum capital requirement would not permit banks to make a sufficient market rate of return on low-risk activities.

Meanwhile, unregulated financial companies, or non-U.S. banks not hindered by the leverage ratio standard, may determine that best-practice estimates of Economic Capital are quite below 5% for some activities – and these non-U.S.-regulated entities can hold actual capital in accordance with the appropriate best-practice measurements of risk.

To the world’s regulators, Basel I has been deemed to have outlived its usefulness because it relied on a one-size-fits-all set of capital ratios. The leverage ratio in the U.S., and the higher U.S. floors during the transition period, are subject to these same concerns. Continued use of the leverage ratio, in particular, seems to

suggest to the uninformed that banks with higher leverage ratios are somehow more “sound” than other banks. In truth, the bank with the higher leverage ratio is simply more likely to be holding high-risk assets – the higher leverage ratio is the market’s natural response to such high-risk assets. The use of a leverage ratio minimum did not prevent insolvency in the late 1980’s in the U.S. – when many savings banks with high capital to assets ratios (sometimes in excess of 20%) failed. In effect, the focus on high capital ratios, because they were deemed to promote safety and soundness, acted as a “cover” for the bank to engage in high-risk activities without proper risk measurement or management. Thus, all the major Basel countries except for the U.S. have rejected use of such a minimum leverage ratio in favor of the risk-based Basel II standard. We therefore believe that the leverage ratio requirement in the U.S. should be used possibly during the transition period, but should be phased out, or at least down, for any Basel II AIRB institution that meets the very stringent standards being attached to AIRB qualification.

Finally, the issue of the Basel II capital requirements being possibly too low is essentially an issue of Pillar 2 supervision. We believe that the U.S. supervisors are the best in the world at assessing the risks of a particular bank’s activities, and, rather than using a minimum leverage ratio or an aggregate floor that may push banks into higher risk activities, U.S. supervisors’ best defense against a mistake in the Basel II formulation is the outcome of their own so-called “99-18” examinations. U.S. supervisors have the unfettered right to require any individual bank to hold substantially more capital than the minimum required by Basel – and the agencies have appropriately used this right many times in the past. Also, if the U.S. supervisors believe that some element of the AIRB approach is really too liberal, then this should be taken up with the full Basel Committee for future change across the full range of Basel countries.

E. Definition of default for wholesale exposures.

There are two issues here.

First, the U.S. definition requires that the bank treat as a default the sale of an asset or group of assets at a “credit-related” loss of 5% or more. This requirement presents severe implementation problems:

1. Identifying “credit-related” loss at sale is highly problematic. Some losses on sale will be related to differences in risk appetite or portfolio construction between the seller and the buyer. Or, the seller may need to sell for reasons of concentration, but market illiquidity at the time may induce a loss of 5%.
2. Conceptually, the loss on a defaulted wholesale asset would be more in the range of 20-40%. This suggests that the U.S. rule should be more flexible, perhaps stated in terms of a “significant credit related loss” rather than with respect to a 5% hard-wired criterion.

Absent a change in this proposed rule, we are greatly concerned that there would be an unintended public policy consequence – discouraging or hampering a well-intentioned bank in its ability to use asset sales to manage the risk of its wholesale loan portfolio.

Second, the differences between the U.S. rule and the already-in-place Basel II rule in the rest of the Basel countries³ will greatly increase the cost of Basel II compliance for multinational banks. Indeed, this cost is already being borne by banks that developed internal databases using the Framework definition and now, in the U.S., must develop new databases using the U.S. definition. These definitional differences will not affect the capital calculation very significantly – the U.S. rule would result in somewhat higher PD calculations but, conversely, would result in somewhat lower LGD calculations. The net effect is a slightly higher overall regulatory capital calculation. But this slightly more conservative result (from the regulatory perspective) comes at a significant additional compliance cost. We therefore suggest, at a minimum, that multinational banking companies be given the option of applying either the U.S. rule or the Framework rule in any of the countries in which they have significant wholesale lending operations. And, we strongly believe that the 5% sale-at-a-loss threshold must be eliminated.

F. U.S. addition of the ELGD versus LGD concept, and the use of the Supervisory Mapping Function.

The ELGD-LGD concept in the U.S. proposal again adds significant compliance burden for U.S. banks. We understand the U.S. rule is aimed at treating the problem of insufficient internal data to produce “downturn” LGD estimates. While the problem is a real one, we believe that the Pillar 2 examination process is sufficient to the task. That is, some combination of internal and external data, along with a bias toward producing a conservative LGD estimate in the absence of sufficient internal data, should be sufficient to satisfy the Framework requirement that LGD be measured as in a “downturn” condition with historically high default rates.

The U.S. ELGD-LGD distinction has several significant problems from the perspective of meeting the prudential objectives of Basel II. First, the U.S. proposal subtracts ELGD times PD from the loss at the confidence interval, rather than subtracting LGD times PD from that calculated loss at the confidence interval. This naturally produces higher risk-weighted-assets (“RWA”) calculations than would the international Basel II Framework for the same portfolio. Especially because these RWA results will be disclosed under Pillar 3, the U.S. methodology will lead to stakeholders thinking that a U.S. bank has a

³ In addition to the “sale at a credit related loss” condition, the U.S. proposal uses non-accrual status as one of the conditions defining default in wholesale exposures, as opposed to 90-days-past-due in the Framework.

riskier portfolio than a non-U.S. bank, even in the case of identically sized portfolios of identical composition.

Second, the Supervisory Mapping Function (SMF) in the U.S. proposal would be required if the bank did not meet supervisory expectations on the proper estimation of LGDs. The SMF, however, unduly penalizes low-LGD assets, because the SMF adds an arbitrary (roughly) 8 percentage points to the measured ELGD. For example, under the SMF, if the bank properly measures ELGD as 10%, the SMF assigns an LGD of 17.2% to the asset – an increase of 72% that may be unsupported by any historical data available to anyone.

Additionally, we are concerned that the SMF, which applies to all credit assets, no matter the underlying historical data, could lead supervisors to incorrectly disqualify a bank's downturn LGD estimate (because the bank's LGD is substantially below the LGD flowing from the supervisory mapping function).

Finally, any such U.S. supervisory reliance on a mapping function would be at odds with the interim fallback-solutions-approach as enunciated in the Basel guidance paper dealing with paragraph 468 of the Framework.⁴ The SMF represents yet another example of U.S. divergence from the international Framework that will result in higher compliance costs but will not improve risk management practices.

G. The U.S. NPR eliminates the international rule's treatment of loans to small-to-medium business enterprises (SME).

Under the international rule, the credit risk equation for such obligors has lower Asset Value Correlations ("AVCs"), to reflect the idiosyncratic nature of defaults of small businesses. That is, defaults of small businesses are not as correlated as those of larger businesses, because the large firms are more influenced by general macro conditions rather than by idiosyncratic conditions in a local market or sub-sector of an industry. By not recognizing this lower risk, the result is that U.S. banks will have to hold more capital against loans to small businesses, which could lead to either a reduced market share of such loans for U.S. banks, or worse, a reduced flow of funds to small businesses in the U.S.

H. The U.S. NPR may differ from the Basel II framework that is being implemented by the SEC for U.S. investment banks.

Investment banks in this country have been required by the SEC to implement the international Basel II Framework. Unless the SEC changes its capital rules to mirror the U.S. banking agency rules, there will be a further competitive inequity for U.S. Basel II banks in relation to their investment banking company competitors.

⁴ "Guidance on Paragraph 468 of the Framework Document," BCBS 115, July 2005, pp. 5-6.

I. The U.S. NPR treatment of equity investments in investment funds with material liabilities is substantially more punitive than the international Basel II standard.

In the NPR, investment funds “with material liabilities” are excluded from investment fund treatment, but it is not clear how such funds should be treated. Our reading of the NPR is that such funds should be addressed within the equity exposure framework.⁵ We understand the agencies’ concern relates to the leverage of such a fund due to liabilities, and suggest that an appropriate risk weight might exceed 400% (the maximum for non-publicly traded equity) in order to appropriately take leverage into account within the context of the equity rules.

We are strongly opposed to the alternative view suggested by regulatory staff in conversations with the industry that investment funds with material liabilities be treated as the synthetic equivalent of the lower tranche in a two tranche securitization, junior to the fund’s liabilities, which would result in a capital deduction (as a first-dollar loss position).

Such a treatment would create a major inconsistency between the capital requirement for an equity position in a leveraged investment fund (effectively a risk-weight of 1250%) versus the maximum risk-weight of 400% for the equity of any other non-publicly-traded company, including investment companies that may be leveraged and have positions similar to investment funds. There is simply no evidence that suggests that an equity position in a hedge fund is more than 3 times riskier than an equity position in a non-publicly-traded financial company.

Even a risk weight of more than 400% (for equity positions in leveraged investment funds), but less than 1250%, would place the U.S. banks at still another competitive disadvantage relative to banks in the other Basel countries. But a risk-weight of 1250% would be unconscionable.

Note that, in thinking about these substantial differences between the U.S. proposal and the Basel II standards in current use by other countries, it is not sufficient to say “Well, all the U.S. operations of the non-U.S. banks will still be subject to the much more conservative U.S. rule – therefore there is no competitive inequity.” First, it is not clear exactly how home-host rules will be implemented, but the general thrust of the NPR is that U.S. rules for Basel II AIRB would be applied to the U.S. subsidiary of a foreign bank only if the U.S. subsidiary meets one of the conditions for “mandatory” status. More importantly, one must recognize that the non-U.S. banking company can engage in double-leverage to avoid any arbitrarily high capital

⁵ Our interpretation is based on Part VI, Section 51, p.55943 of the NPR. “To calculate its risk weighted asset amounts for equity exposures that are not equity exposures to investment funds, a [bank] may apply either the Simple Risk Weight Approach (SRWA) in section 52 or, if it qualifies to do so, the Internal Models Approach (IMA) in section 53.”

requirement under the U.S. rule – by borrowing at the level of the foreign parent and down-streaming the proceeds in the form of equity investment in the U.S. subsidiary.

III. Other issues of top-importance within the NPR.

A. Asset-Value-Correlations (“AVCs”) are higher than they should be for some important credit positions.

This is a Basel Committee issue, not just a U.S. issue. Industry studies, including several papers completed by the RMA Capital Working Group, have indicated that AVCs are too high, and/or the slope of the relationship between AVCs and PD is inappropriate for products such as commercial loans, first-lien mortgages, multi-family commercial mortgages, home-equity lines of credit, and credit card exposures. We ask only that the Committee continually review the evolving research on this subject, and occasionally revise the AVCs in the Basel II AIRB credit risk equations when the weight of the evidence compels such changes to be made. In the worst case, failure by the Committee to revise the AVCs may result in inappropriate incentives for regulated banks to reduce flows of loanable funds to specific credit sectors, through no fault of the obligors, and with no improvement (indeed, a deterioration) in the measurement by regulators of the overall soundness of the bank.

B. The question in the NPR (Question 15) dealing with “downturn conditions” at the sub-product level reflects a view that is counter-productive to meeting prudential objectives.

We are very concerned that the agencies would consider applying “downturn conditions” at the sub-product level. The result would be higher LGDs, and therefore higher capital requirements, for the credit portfolio as a whole – but this is NOT in the interest of good public policy with regard to risk-based capital requirements. In previous research conducted by the Capital Working Group⁶ we have found that even at the major product level (mortgages versus credit cards, for example), let alone at the sub-product level, defaults are not driven by a single, uniform “risk-factor” as is assumed by the simple Basel II credit risk model. As a result, periods (quarters or years) of high default rates do not overlap for the major product lines – and may overlap even less for sub-products. Therefore, product diversification in the credit arena is a highly efficient way of reducing portfolio risk for the major institutions. Any departure from the Framework, along the lines of requiring downturn periods to be defined at the sub-product level, would further the disincentive to achieve such product differentiation (such disincentive already flows from the requirement to define different downturn periods for each Basel II credit product category).

⁶ “Downturn LGDs for Basel II,” RMA Capital Working Group, August 2005.

C. There is no incentive for banks to adopt the internal models approach (IMA) for equity exposures

We are in support of the directionally more risk-based and conservative rules regarding capital for equity positions. However, the new rule requires that, if a bank chooses the IMA, this approach must be applied to positions below as well as to above the “non-significance” threshold. Since all positions would then be subject to 200% or 300% floors, this would make the IMA punitive in relation to the Simple Risk Weight Approach (“SRWA”) and would likely discourage use of the IMA.

Still other equity treatment anomalies are discussed in our responses to the specific NPR questions on equity treatment.

D. The definition of “securitization exposure” in the U.S.

The U.S. proposal (p. 55881) calls for the securitization framework to be applied to “exposures to any transaction that involves the tranching of credit risk...” Our understanding is that, under this definition, the structured financing of a single asset would be subject to securitization treatment. Thus, a structured loan to a commercial enterprise would no longer be treated under the wholesale risk equation but under the hierarchy of approaches for securitization (deduction, RBA, IAA for ABCP, or SFA).

We believe that securitization treatment should be intended for pools of underlying assets, where the issue of loss correlation – among the assets in the pool, and between a particular securitization tranche and the other holdings of the bank – is paramount. We can see where the structured financing of a small number of assets would look similar to an ordinary securitization, if the more senior tranches continue to receive cash principle and interest payments from the underlying pool even if some assets in the pool default.

However, in the case of a structured financing of a single asset, typically each of the tranches is deemed to be in default, if the underlying obligor fails to make contractual principal and interest payments. In such a case, the senior tranches effectively face a zero or close-to-zero LGD, while the junior tranches incur losses as the underlying asset is liquidated and the cash proceeds distributed to the tranches in order of seniority. Effectively, in such a transaction, each of the tranche holders should assign the same PD to their tranche, but radically differing LGDs based on seniority. At a minimum, therefore, we believe that U.S. regulators should specifically exclude such a structured financing from securitization treatment. Note that the NPR specifically mentions that “exposures resulting from the tranching of the risks of nonfinancial assets are not subject to the proposed rule’s securitization framework, but generally are subject to the proposal’s rules for wholesale exposures.” However, we believe the exemption from securitization treatment

should be extended to any structured financing, even that of a financial asset, so long as each of the tranches enters default status upon non-payment of the underlying obligation (i.e., so long as the differentiation across tranches is with regard to LGD, not PD).

IV. Responses to NPR Questions.

We present our responses to the questions in the order in which the questions have been arrayed in the NPR. The responses to certain questions are left up to other trade association groups, including RMA's AMA Group dealing with operational risk capital.

Question 1: The agencies seek comment on and empirical analysis of the appropriateness of the proposed rule's AVCs for wholesale exposures in general and for various types of wholesale exposures (for example, commercial real estate exposures).

Question 2: The agencies seek comment on and empirical analysis of the appropriateness and risk sensitivity of the proposed rule's AVC for residential mortgage exposures--not only for long-term, fixed-rate mortgages, but also for adjustable-rate mortgages, home equity lines of credit, and other mortgage products--and for other retail portfolios.

Answers to Question 1 and 2:

Changes in AVCs should be instituted by the Basel Committee as a whole, to avoid competitive inequities and compliance burden. With that caveat in mind, we believe that the Framework's AVCs are much higher than best practice estimates for several retail product categories⁷ and somewhat higher than best practice in wholesale.⁸ Additionally, the slope of the relationship between wholesale AVCs and PD may be inappropriate.

With respect to the PD-AVC relationship in wholesale, we believe that AVCs are related to size of obligor – larger obligors, other things equal, will have asset values that are more sensitive to macro economic conditions – thus, AVCs are lower (defaults more

⁷ The Basel Committee's choice of a mortgage AVC has relied primarily on a FRB paper, "The Asset-Correlation Parameter in Basel II for Mortgages on Single-Family Residences," Paul Calem and James Follain, November, 2003. Another paper, "Best-Practices in Mortgage Default Risk Measurement and Economic Capital," May, 2002, David Kaskowitz, Alexander Kipkalov, Kyle Lundstedt, and John Mingo, detailed research supported by a large mortgage lender. This research suggested that AVCs for fixed rate and variable rate mortgages would, in the context of the Basel II ASRF model, be significantly less than 10%. The RMA Capital Working Group paper, February 2003, "Retail Credit Economic Capital Estimation – Best Practices" indicates that best-practice banks almost uniformly use effective AVCs (for internal ECap purposes) of 10% or less. Other work in the future can be expected to shed light on a) the degree to which HELOCs may have lower AVCs than term first mortgages, and, conversely, whether "non-traditional" mortgages of various types may have higher or lower effective AVCs than traditional first mortgages.

⁸ See Gareth Gore, "Correlation confusion," *Risk Magazine*, July/August 2006 | Volume19/No7; also, Ashish Dev, "The correlation debate," *Risk Magazine*, October 2006 | Volume19/No10; also, "Response to the Proposed U.S. Supervisory Guidance for Retail Credit Risk Capital under the Basel II Framework," pp. 15-16, RMA Capital Working Group, January 2005

idiosyncratic) for small to medium-sized enterprises. This view is shared by the rest of the Basel countries, in the form of the “SME” AVCs within the Framework document.

In commercial real estate (CRE) lending, many observers believe that multi-family lending (MFL) should have lower AVCs than other C&I lending, because a multi-family loan has some of the characteristics of a retail loan – being highly sensitive to local market conditions rather than to the (single) macro risk variable associated with the Basel II wholesale credit risk model. However, there is no clear publicly available research on this issue.⁹

Question 3: The BCBS calibrated the proposed 0.6 percent limit on inclusion of excess reserves in tier 2 capital to be approximately as restrictive as the existing cap on the inclusion of ALLL under the general risk-based capital rules, based on data obtained in the BCBS's Third Quantitative Impact Study (QIS-3). The agencies seek comment and supporting data on the appropriateness of this limit.

Answer to Question 3:

The RMA Capital Working Group believes that the ALLL should be counted as real equity – it is the first “type” of capital to absorb credit losses. Indeed, the ALLL was treated in the U.S. as a part of “Primary Capital” in the 1980’s. Note also that the rating agencies typically view the ALLL as true equity, along with tangible equity, including permanent preferred and trust preferred.

At a minimum, there should never be *any* limit on the amount of the ALLL that counts as Tier 2 capital.

The 0.6% of RWA limit is distorted in the U.S. by the fact that the U.S. requires higher capital to cover unexpected losses (UL). In the U.S. version, ELGD*PD is subtracted from loss at the confidence interval (rather than LGD*PD). As a result, RWA is higher in the U.S. than in the other Basel countries. Conversely, in the U.S., ELGD*PD is subtracted from the ALLL to determine what portion of the ALLL is eligible for inclusion in Tier 2, while, in Europe, LGD*PD is subtracted from the ALLL.

The net effect of these U.S.-only changes will depend on the specifics of the bank’s portfolio composition.

- a. Consider a bank that, under the European rule, would have its ALLL-EL run up against the 0.6 percent of RWA limit. For such a bank, the U.S. rule would raise the ALLL-EL limit by an amount equal to

$$(i) \quad 0.6\% * (LGD - ELGD) * PD * \$EXP * 12.5,$$

⁹ See Lopez, Jose, “Empirical Analysis of the Average Asset Value Correlation for Real Estate Investment Trusts,” 2005, Working paper 2005-22, Federal Reserve Bank of San Francisco. Lopez finds that multi-family loans have AVCs somewhat higher than other IPRE but lower than the Basel II AVCs for HVCRE. Unfortunately, the underlying data apparently do not distinguish between permanent loans and acquisition, development, and construction loans (ADC).

where LGD and ELGD are the relevant LGD percentages, \$EXP is the dollar amount of exposures, and 12.5 is the multiplier that is applied to the dollar amount of total capital requirement in order to arrive at \$RWA.

For such a bank, this increase in the ALLL-EL limit is *significantly below* its increase in ALLL-EL as a result of “EL” being defined, in the U.S., as $ELGD*PD$ rather than $LGD*PD$.¹⁰ Therefore, relatively less of this bank’s ALLL would be counted as Tier 2 capital than under the European rule.

- b. Next, consider a bank for which, under the European rule, its ALLL is not close to being subject to the 0.6% of RWA limit. For this bank, the amount of the ALLL that can count as Tier 2 (absent the limit) goes up by 13.3 times the increase in its limit (as per footnote 1, the increase in the limit is 7.5% of the increase in the ALLL-EL calculation). This may bring the limit into play where it was clearly not in play before.
- c. For a bank with $ALLL < EL$, under both the U.S. and European rules the bank must deduct the shortfall 50% from Tier 1 capital and 50% from Tier 2 capital. The U.S. version of ALLL-EL reduces the amount of the shortfall – and therefore the amount of the reductions in Tier 1 and Tier 2 capital, by the amount shown in footnote 9. For this bank, the ALLL-EL improvement is welcomed and may be insufficient to turn the ALLL-EL calculation positive and sufficiently positive to come up against the new, higher U.S. version of the ALLL limit.
- d. In summary, for all of these banks subject to the U.S. rule, the improvement in the amount of ALLL they can count as Tier 2 capital (absent the limit) is exactly equal to the increase in their total capital requirement under the U.S. rule.¹¹ For some of the U.S. banks, however, the increase in the ALLL-EL calculation may bring the limit into play such that the increase in the Total Capital requirement is substantially above the increase in their *usable* ALLL-EL calculation. Moreover, for all U.S. banks, since \$RWA unambiguously rises due to the U.S. rule, the rule has the effect of raising the Tier 1 capital requirement relative to the non-U.S. banks.

We think that there are several equitable ways to relieve this problem:

¹⁰ In particular, the U.S. version of the \$limit on the ALLL = $0.6\% * \$RWA$, where $\$RWA = (TL - ELGD*PD)*\$EXP*12.5$, and TL refers to the percentage Total Loss at the 99.9th percentile. The European version of \$RWA is the same as the U.S. except that “LGD” is substituted for “ELGD”. Then, the increase in the dollar ALLL limit associated with the U.S. rule is $\Delta\$Limit = 0.6\%*(LGD-ELGD)PD*\$EXP*12.5$. Meanwhile, the change in the ALLL-EL calculation associated with the U.S. rule is given by $\Delta\$(ALLL-EL) = (LGD-ELGD)*PD*\EXP . Therefore, the $\Delta\$Limit$ is only 7.5% of the $\Delta\$(ALLL-EL)$.

¹¹ The dollar Total Capital requirement is $TC = (TL-LGD*PD)*\$EXP$, where TL, LGD (or ELGD) and PD are expressed as percentages of exposure. Thus, $\Delta\$TC = (LGD-ELGD)*PD*\EXP which is identical to the increase in the ALLL-EL permitted to be used in Tier 2 (as per footnote 1 above) *absent any ALLL limit*.

- o Eliminate the U.S. treatment of ELGD vs. LGD
- o Raise the U.S. version of the ALLL limit. For example, the U.S. limit could be set equal to $0.6\% \times \text{RWA}$ plus $92.5\% \times (\text{ELGD} - \text{LGD}) \times \text{PD} \times \EXP , thereby making the increase in the limit exactly equal to the increase in ALLL-EL.
- o Impose no limit on the amount of the ALLL that can count as Tier 2 capital (there being no prudential reason for such a limit).
Further, we should note that a U.S. decision to do this would not be contrary to our general position that the U.S. rules and European rules should be closely harmonized. Rather, the ALLL practices in the U.S. are unique and result in typically much higher levels of reserves than in other Basel countries. Over time, these reserves have been built up via charges to income in the form of provisions. Thus, all things equal, the U.S. banks have lower equity and higher ALLL than European banks – simply as a result of the provisioning process. A U.S.-only rule to permit an unlimited amount of ALLL-EL within Tier 2 would not constitute a competitive inequity for non-U.S. banks – but failure to do so would constitute such an inequity for U.S. banks.
- o Remove the ALLL-EL charge for all Basel banks completely.

We have addressed these last two approaches in several earlier RMA papers. We have shown that the ALLL is available for absorbing Unexpected Losses because asset yields more than cover Expected Losses. See, for example, a recent paper that shows that yields on assets that do not default, are more than sufficient to cover EL, even during a tail event (when defaulted assets are higher even than observed historically).¹²

Question 4: The agencies seek comment on the use of a segment-based approach rather than an exposure-by-exposure approach for retail exposures.

Answer to Question 4:

The RMA Capital Working Group (“CWG”) believes that the rules should be neutral toward how a bank measures, for internal risk metric purposes and for Basel II purposes, the “segments” of a retail product. Currently, some best-practice banks measure PDs, LGDs, and EADs, based on product line segments that, in turn, are based on important risk characteristics such as loan-to-value, delinquency status, FICO score, age of loan, and other measures. Basel II risk parameters such as PD are measured as the historically observed mean of default rates in each segment – where a segment is defined in terms of *ranges* of the important risk characteristics. For example, a particular segment for mortgage loans may consist of loans with a) FICO scores between 600 and 660, b) LTVs

¹² See “Future Margin Income and the EL Charge for Credit Cards in Basel II,” The RMA Journal, September 2006, pp. 46-51.

between 70 and 79%, c) in a delinquency state of 1-29 days-past-due, and d) in an age bracket of 24-48 months since origination. The bank may have literally 100s or even 1000s of such defined buckets for each product line or for each sub-product (e.g., first mortgages originated by a particular subsidiary). Capital – either for Basel II purposes or for internal ECap purposes – is then measured for each of these defined segments.

Still other banks measure risk parameters, Basel II capital, and internal ECap, at the individual loan level. For example, a bank may develop a series of logistic regressions for each of its products and sub-products in its retail portfolio. To provide an example that is based on the same “segment” characteristics as above, the bank could find that default rates are functionally related to delinquency status, FICO score, LTV, and age – but instead of measuring these effects via defined segments, the bank applies a best-fit logistic regression (based on these 4 explanatory variables) to each individual loan in the portfolio. Portfolio segments that are used either for Basel II reporting purposes or internal risk reporting purposes may then have their PDs estimated as the exposure-weighted mean of the loan-level PDs stemming from the estimated logistic regression. Some observers believe that this exposure-by-exposure risk measurement procedure produces the most accurate capital charges, but the evolution of the risk estimation process continues.

Still other segmentation or loan-level estimating procedures might be used, including combinations of the procedures above. So long as the bank is not producing the required Basel II risk parameter estimates in a purposely biased fashion -- to reduce regulatory capital requirements -- supervisors should permit a wide array of risk parameter estimation procedures. Regulatory burden, in particular, can only be held in check if the bank does not have to “do things twice” – once for internal purposes and once for Basel II purposes. Perhaps most importantly, supervisory flexibility allows and encourages continued evolution of risk measurement and management processes.

Question 5: The agencies are, in short, identifying a numerical benchmark for evaluating and responding to capital outcomes during the parallel run and transitional floor periods that do not comport with the overall capital objectives outlined in the ANPR. At the end of the transitional floor periods, the agencies would re-evaluate the consistency of the framework, as (possibly) revised during the transitional floor periods, with the capital goals outlined in the ANPR and with the maintenance of broad competitive parity between banks adopting the framework and other banks, and would be prepared to make further changes to the framework if warranted. The agencies seek comment on this approach to ensuring that overall capital objectives are achieved.

Answer to Question 5:

The series of “floors” within the U.S. NPR differ from the European version in several significant ways:

- There are 3 transition periods in the U.S. version rather than 2.
- The U.S. transition periods may last longer than one year each, depending on the circumstances of the individual institution.
- The U.S. percentage floors during each transition period are higher than in the European version.

- There is an “aggregate floor” in the U.S. version.
- The U.S. has a very significant minimum leverage ratio requirement.

We appreciate the agencies’ need to be conservative; however, the cumulative conservatism of these floors will serve to distort the effects of prudential policy, and may result in significant competitive inequities. Moreover, the agencies’ concern regarding possible capital reduction can be more appropriately addressed through the Pillar 2 process. It should be remembered also that the U.S. agencies already have the authority to require any institution to raise its capital level, and furthermore, any possible capital reduction will no doubt be constrained by the bank’s need to maintain a strong rating from the public rating agencies. In the end, the floors and cumulative conservatism are really not necessary for prudential purpose, but only add to the already steep compliance burden and serve to foster an environment of uncertainty.

i) Costs versus benefits for the bank -- versus prudential policy objectives of the regulator. All Basel II banks will have spent many millions of dollars to implement the new capital regime and maintain it going forward. However, no matter how safe are the asset holdings of the Basel II bank in the U.S., there will be a lower bound to their regulatory capital requirement, during the transition periods, of no less than 85% of the Basel I requirement. Because Basel II is intended to be more risk-sensitive, any significant movement toward lower risk would naturally reduce the Basel II capital requirements in the absence of these floors. Therefore, the transition floors (during a transition period that will last at least 3 years) *will dissuade U.S. banks from moving toward lower-risk activities.*

Compounding this problem, any set of banks that do decide to lower their risk would possibly penalize all U.S. Basel II banks through invocation of the 10% aggregate limit on the reduction in capital. The U.S. individual bank and aggregate floors, therefore, provide a good example of unintended consequences that are directly opposite those intended by sound prudential policy objectives.

ii) The existing leverage ratio floor in the U.S. compounds further this problem of unintended consequences. Several U.S. banking companies are already hindered by this ratio requirement with regard to their ability to originate and manage low-risk credits on their balance sheet. Basically, the leverage ratio requirement reduces the low-production-cost advantage of very large banks with respect to low-risk credits, forcing the banks either to securitize such credits or “match” them with high risk credits (in order for the leverage ratio requirement to bear some semblance to the best-practice estimate of economic capital). This is potentially a distortion of credit flows that runs counter to the objective of having a safe banking system that is instrumental in funding economic growth.

Certainly, the U.S. banking agencies are not opposed to low-risk lending or insensitive to the economic growth prospects of low-risk individuals or corporations – but that is the incentive-distorting effect of their policies toward “floors” for capital ratios.

iii) Finally, it is clear to us that the issue of capital requirements being possibly too low at any individual bank is essentially an issue of appropriate Pillar 2 and Pillar 3 requirements -- not mandated capital ratio floors that run counter to the mission of Basel II. We believe that U.S. supervision of banks and BHCs is among the very best in the world. Large U.S. banking companies especially are subject to continual, on-site supervision. We have absolutely no problem with supervisors imposing constraints on risk-taking, requiring higher capital than the bank thinks it needs, etc. – where, in individual circumstances, the bank does not meet acceptable standards for risk measurement and management.

Question 6: The agencies seek comment on all potential competitive aspects of this proposal and on any specific aspects of the proposal that might raise competitive concerns for any bank or group of banks.

Answer to Question 6:

a. U.S. Basel II banks versus non-U.S. Basel II banks. We have major concerns as expressed in the Overview section at the beginning of this response paper. There are clear competitive equity issues associated with the differences between the U.S. proposal and the Framework now being implemented in the other Basel countries:

- The various floors in the U.S. are more stringent than in Europe.
- Altered U.S. definition of default in Wholesale.
- Multiple definitions of LGD – i.e., ELGD and DLGD.
- Differences between the U.S. NPR and the European-version NPR that will be applied to U.S. investment banks (placing U.S. Basel II banks at a disadvantage to U.S. investment banks).
- Elimination of the SME credit risk formula in the U.S.
- Conservative U.S. treatment of equity positions in hedge funds.
- Potential for continued delay of implementation in the U.S.

Note that all of these competitive equity issues do not necessarily face the U.S. operations of foreign BHCs. Even if home-host rules were set to make the non-U.S. Basel II banks subject to the U.S. rules, such companies have two devices for avoiding the harsher U.S. rules:

- Via the use of a U.S. division or branch of a foreign bank.
- Via the use of double-leverage (the foreign BHC's consolidated capital requirements are set by the non-U.S. version of Basel II, while the foreign BHC can issue debt and downstream the proceeds in the form of an equity holding in the U.S. bank).

b. U.S. Basel II banks versus U.S. non-Basel II banks. Smaller U.S. banks have expressed concerns that they will be at a competitive disadvantage if large U.S. banks receive a “capital reduction” associated with Basel II. However, we do not believe that the competitive landscape in the U.S. will necessarily change because of Basel II:

- Large banks have benefited from economies of scale and scope, while smaller banks have benefited from “high touch” (stronger relationships with individual corporations and individuals). This won’t change.
- Small banks’ capital levels are unrelated to the current Basel requirements (are generally much higher, reflecting concerns over diversification and risk management capabilities). This won’t change.
- Small banks generally are “price-takers” (do not affect market prices on a wide array of credit products). When combined with unchanged capital requirements for small banks, this means that small banks ROEs should not change with the advent of Basel II, (unless Basel II affects the asset yield calculations of large price-setters – i.e., unless Basel II becomes binding on the price-setters).¹³

A major effect of Basel II, within the U.S. proposal, is to impose inappropriately high capital requirements on the low-risk lending of Basel II banks, especially in the U.S., where there are higher “floors”, and there is a minimum leverage ratio requirement. For both U.S. and non-U.S. Basel II banks there are also lower bounds to PDs and LGDs. These rules serve to push AIRB banks out of low risk lending, or at least reduce the growth of such lending by AIRB banks in general and U.S. AIRB banks in particular. Small banks, on the other hand, do not typically hold high percentages of low risk assets such as conforming mortgages or participate in low risk loans to highly-rated corporations (primarily because the low yields on such assets do not generate sufficient ROE on the high capital levels smaller banks are expected to hold). Rather, small banks help originate some such low-risk loans, under origination policies set by the large lenders. If the more conservative U.S. policies toward the low risk lending of price-setters forces some U.S. AIRB banks to cut back in this arena, or reduce growth in the sector, small U.S. banks may, as a result, lose some fee-based business. Thus, alignment of U.S. rules with those of the rest of the Basel countries can serve to reduce competitive inequities for banks of all sizes in the U.S.

Question 7: The agencies request comment on whether U.S. banks subject to the advanced approaches in the proposed rule (that is, core banks and opt-in banks) should be permitted to use other credit and operational risk approaches similar to those provided under the New Accord. With respect to the credit risk capital requirement, the agencies request comment on whether banks should be provided the option of using a U.S. version of the so-called “standardized approach” of the New Accord and on the appropriate length of time for such an option.

Answer to Question 7:

Please refer to our response in Section II, pp. 2-3 of this paper. The Framework choices (Standardized, Foundation IRB, and Advanced IRB) should be made available to all U.S. banks. Competitive equity requires it. At a minimum, if the U.S. continues to require the AIRB approach for certain “mandatory” institutions, these banks should be permitted to

¹³ See a recent FRB paper on the effect of Basel II on home mortgage conditions and prices, “The Competitive Effects of Risk-Based Bank Capital Regulation: An Example from U.S. Mortgage Markets,” FRB, *Finance and Economics Discussion Series*, Diana Hancock, Andreas Lehnert, Wayne Passmore, and Shane Sherlund, August 2006. The paper concludes there will be no significant asset yield effects or market share changes.

use the Standardized approach for certain portfolios or for certain risk types (e.g., for operational risk capital purposes) during the entire transition period. Providing this sort of flexibility will reduce the extremely high costs of compliance.

Question 8a: The *Board* seeks comment on the proposed BHC consolidated non-insurance assets threshold relative to the consolidated DI assets threshold in the ANPR.

The RMA CWG leaves the answer to Question 8a to those institutions that have now or may have in the future insurance activities for which the question is relevant.

Question 8b: The agencies seek comment on the proposed scope of application. In particular, the agencies seek comment on the regulatory burden of a framework that requires the advanced approaches to be implemented by each subsidiary DI of a BHC or bank that uses the advanced approaches.

Answer to Question 8b:

Best practice internal Economic Capital (“ECap”) procedures generally are applied at both the level of the consolidated company and down to the level of the business line – but not typically at the level of the depository institution. This precision at the business *line* level is often viewed as required by the market. However, the shares of the DI are not typically traded nor does the DI always issue rated debt obligations.

In the U.S., furthermore, bank holding companies are supposed to be a “source of strength” to individual banking subsidiaries. Indeed, a well-capitalized BHC or depository institution affiliate of a troubled DI affiliate is supposed to come to the aid of the troubled bank. Therefore, maintaining capital ratio requirements at the DI – through the imposition of Basel I or the *Standardized approach to Basel II* – should be sufficient to meet the prudential objectives of regulators (without incurring the significant added costs of calculating Basel II requirements at the DI level). Indeed, the Standardized approach should generally produce more conservative capital treatment at the DI level. Alternatively, the “top of the house” capital requirement computed using the Basel II approach could be distributed across the DIs via their relative Basel I or Standardized capital calculations.

Question 9: The agencies seek comment on the application of the proposed rule to DI subsidiaries of a U.S. BHC that meets the conditions in Federal Reserve SR letter 01-01 and on the principle of national treatment in this context.

Answer to Question 9:

It is our understanding that the proposed treatment would bring the U.S. subsidiaries of the foreign banking organization into consistent treatment with U.S.-based banking organizations (as regards *mandatory* AIRB treatment), except for U.S. banking subsidiaries that are subject to SR 01-01. That is, if a U.S. subsidiary of the foreign institution meets one of the conditions for mandatory status it would be subjected to the U.S. version of the Basel II AIRB approach. However, if the foreign institution is a financial holding company (FHC) under the Gramm-Leach-Bliley Act, the U.S.

subsidiary would have to calculate and report capital ratios under the Fed's capital requirements, but would not have to *meet* the minimum capital ratio requirements.

This potential competitive inequity is furthered, as noted in our response to Question 5 above, to the extent that the foreign-owned banking organization, at the level of the consolidated entity, is neither *required* to use the AIRB approach on a consolidated basis by its home country, nor is it subject to the potential flow-of-funds-distorting effect of the higher transition floors or the minimum leverage ratio requirements that exist in the U.S. This means that, even in the case where the U.S. subsidiary BHC is not privileged by SR 01-01, application of the U.S. rules just to the U.S. subsidiary of the foreign BHC has no real economic effect -- because of the foreign entity's ability to use devices such as double-leverage to avoid the inappropriate floors and minimum leverage ratio. In effect, the U.S. subsidiary of the foreign institution is not subject to our rules and can operate under the rules of its home country where it matters.¹⁴

Question 10: The agencies seek comment on this approach, including the transitional floor thresholds and transition period, and on how and to what extent future modifications to the general risk-based capital rules should be incorporated into the transitional floor calculations for advanced approaches banks.

Answer to Question 10:

See discussion above, under our Introduction and Overview and the response to Question 6. Note also that building in such floors and constraints in relation to a new Basel IA (rather than in relation to the current Basel I), would require mandatory or opt-in Basel II banks in the U.S. to develop still another risk measurement and reporting system (Basel IA) for use solely during the transition periods -- in addition to the three they already have established (Basel II AIRB, Basel I, and internal Economic Capital). This increased burden to the AIRB bank generates no regulatory benefit in terms of assessing bank soundness.

Question 11: The agencies seek comment on what other information should be considered in deciding whether those overall capital goals have been achieved.

Answer to Question 11:

In past RMA CWG papers we have emphasized that there is no known substitute for Economic Capital-based systems for measuring risk and assessing appropriate capital adequacy given those risks. Basel II has embraced the main concepts underlying Economic Capital.

¹⁴ It is important to note that, precisely because the foreign banking organization is *not*, on a consolidated basis, subject to the U.S. minimum capital rules, a U.S. rule requiring that the foreign bank's "mandatory" U.S. subsidiary must calculate its capital using the U.S. version of the AIRB approach is clearly punitive. As noted above, we believe competitive equity consideration mandate that all banks in all countries should be afforded the option of calculating their minimum capital standards by any one of the three Basel standards -- Standardized, Foundation, or AIRB. The rigor of the U.S. 99-18 exams should then become relatively more important in the case of large, complex U.S. banking companies, whether or not these companies are owned domestically.

Basel II provides, for the first time, a well-defined soundness standard – capital sufficient to maintain no more than a 0.1% chance of insolvency over the next year. However, this calculation of required capital is increased via the well-capitalized rules in the U.S., which drive up the Total Capital requirements by another 25% (and the Tier 1 requirements by another 50%).

These add-ons, when coupled with the cumulative conservatism of the U.S. version of Basel II, run at odds with market best-practice estimates of capital necessary to maintain high soundness. The agencies should be especially careful to incorporate within their standards the views of, for example, rating agencies, some of whom are saying that U.S. banks now hold, under Basel I, and under the leverage ratio requirement, enough capital to vault the ratings of senior subordinated debt into the AA+ and even AAA levels.

If the cumulative conservatism of the U.S. Basel II rule were to push all U.S. Basel II banks to such a high rating level, it is possible that U.S. banks could not fulfill to the greatest extent possible their social objective of underwriting economic growth while maintaining reasonably high soundness levels.

Regulators should also consider that, as best-practice measurements of risk (and therefore of Economic Capital) continue to evolve, the minimum regulatory capital regime should also evolve. We have begun to document how the AVCs associated with the Basel II framework may be too high in some cases – in this vein, regulators throughout the Basel community should resolve to conduct a serious review of these AVCs at, say, the end of the transition period, to be followed by, say, bi-annual reviews thereafter.

Question 12: The agencies seek comment on this proposed timetable for implementing the advanced approaches in the United States.

Answer to Question 12:

- a. The timetable has already placed U.S. banks at a competitive disadvantage to other Basel II banks. Yet, the additional complexity associated with the U.S. rules, and the complex supervision process in the U.S. (as well as the delay in publishing the updated Supervisory Guidance), means that even this timetable may be too ambitious.
- b. The added complexity of the U.S. rules and supervisory procedures almost certainly will keep some opt-in institutions from being able to opt-in at roughly the same time as the mandatory banks. Mandatory banks may also not be able to complete their qualification process close to the time of initiation of the U.S. rules. Therefore, as we have discussed earlier, allowing use of the Standardized approach for certain portfolios or certain risk types would help greatly in the transition process.

Question 13: The agencies seek comment on this aspect of the proposed rule and on any circumstances under which it would be appropriate to assign different obligor ratings to different

exposures to the same obligor (for example, income-producing property lending or exposures involving transfer risk).

Answer to Question 13:

Many of the CWG's members, for internal ECap purposes in the case of income-producing real estate loans, define separate obligor ratings (and/or obligor PD estimates) for separate exposures of the same obligor. Such obligor versus facility distinctions are not necessary in the case of Special Purpose Vehicles owning only a single IPRE property.

For multiple IPRE loans to the same obligor, however, there may exist explicit provisions that forbid cross-default treatment (in which all the facilities are deemed to be in default if the obligor defaults on one facility). Further, the probability that the obligor will default on any one facility is related primarily to the cash flows from the individual property, not to the overall condition of the obligor. When such cash flows decline, underlying collateral value declines, and when either the cash flows cannot service debt or the collateral value falls below loan value, the obligor will be likely to default.

Further, some states have "single-action" laws in which, in the event of non-payment, the lender can "go after" either the obligor or the collateral, but not both. In practical terms, judicial proceedings to force the obligor into bankruptcy are not as fast, and may be more expensive, than simply proceeding to foreclosure on the collateral. Thus, collateral value in such cases importantly determines both default probability and recovery.

For these reasons, in the case of IPRE (including multi-family residential loans), PDs should appropriately be assigned to the facility, with differing PDs across different facilities of the same obligor. Further, treating a single facility default as a default of all facilities would bias PD estimates upward. Note that, since this would also bias LGDs downward, the overall effect on regulatory capital would be slightly in the downward direction.

It is also important to note that some CWG members, in the case of an IPRE loan – even one with cross-default prohibitions and in a single-action state – do assign a single PD to the obligor. We therefore suggest that the U.S. regulators permit flexibility on the part of the bank; subject, of course, to supervisory examination to preclude any cherry-picking or other inappropriate risk measurement practice.

Question 14: The agencies seek comment on this proposed definition of default and on how well it captures substantially all of the circumstances under which a bank could experience a material credit-related economic loss on a wholesale exposure. In particular, the agencies seek comment on the appropriateness of the 5 percent credit loss threshold for exposures sold or transferred between reporting categories. The agencies also seek commenters' views on specific issues raised by applying different definitions of default in multiple national jurisdictions and on ways to minimize potential regulatory burden, including use of the definition of default in the New Accord, keeping in mind that national bank supervisory authorities must adopt default definitions that are appropriate in light of national banking practices and conditions.

Answer to Question 14:

We have answered this question at length in our Introduction and Overview section. In particular, our major concern is with the burden of calculating PD and LGD under the rule that asset sales at a “credit related” loss of 5% or more should be treated as a “default”. We further wish to emphasize two other issues:

- a. The definition of default issue is, at its heart, a Pillar 2 issue. If the bank uses a definition so that PD is higher than otherwise, then LGD will be lower than otherwise, and vice versa.
- b. LGD enters into the credit risk equation in linear fashion while PD enters in less-than-linear fashion (so that regulators have a bias toward default definitions that lower PDs and raise LGDs). However, the impact on capital will be minor in either case. Yet, there are very significant regulatory burden issues as well as issues of fairness.

These facts argue for permitting significant flexibility to the multinational bank to choose between the European and U.S. versions of the default definition for wholesale credits – the choice will have very little impact on regulatory capital calculations but will help to reduce compliance burden.

Question 15: In light of the possibility of significantly increased loss rates at the subdivision level due to downturn conditions in the subdivision, the agencies seek comment on whether to require banks to determine economic downturn conditions at a more granular level than an entire wholesale or retail exposure subcategory in a national jurisdiction.

Answer to Question 15:

- a. Such a move would run counter to the economics of risk measurement. Our paper published in 2005¹⁵ indicated that periods of high defaults do NOT overlap across various broad credit product-types. The Basel II ASRF model treats the product categories as all responding to the same single macro “risk factor” (i.e., the general level of economic activity) when, in fact, the opposite is true. Each type of product responds to somewhat different macro factors (housing prices versus unemployment levels, interest rates versus regional downturns, etc.). Therefore, product diversification is a highly efficient means of reducing portfolio risk for banks.
- b. Moving to use of “downturn LGDs” delineated by *sub-product* categories would create disincentives to engage in product diversification and, as well, would constitute an inappropriate degree of conservatism that would drive regulatory capital up even further in relation to best-practice economic capital.
- c. Finally, such a move would make the U.S. Basel II rules even more at odds with the existing international Basel II standards, making capital requirements for all

¹⁵ See “Downturn LGDs for Basel II, RMA Capital Working Group, August 2005. In particular, we find that historical periods for high default rates tend not to occur during the same year or years for retail versus wholesale products or, within the retail category, for different types of retail products. We therefore recommended that Basel II take into account the natural cross-product diversification benefit that flows from different products responding to alternative macro risk factors. For example, home mortgage defaults would respond to house price levels and interest rates, while business loan defaults could respond to general or sector macro conditions.

- sorts of credit products at U.S. banks even higher than such requirements for non-U.S. banks – still another type of competitive inequity.
- d. Finally, compliance burden would increase significantly.

Question 16: The agencies seek comment on and supporting empirical analysis of (i) the proposed rule's definitions of LGD and ELGD; (ii) the proposed rule's overall approach to LGD estimation; (iii) the appropriateness of requiring a bank to produce credible and reliable internal estimates of LGD for all its wholesale and retail exposures as a precondition for using the advanced approaches; (iv) the appropriateness of requiring all banks to use a supervisory mapping function, rather than internal estimates, for estimating LGDs, due to limited data availability and lack of industry experience with incorporating economic downturn conditions in LGD estimates; (v) the appropriateness of the proposed supervisory mapping function for translating ELGD into LGD for all portfolios of exposures and possible alternative supervisory mapping functions; (vi) exposures for which no mapping function would be appropriate; and (vii) exposures for which a more lenient (that is, producing a lower LGD for a given ELGD) or more strict (that is, producing a higher LGD for a given ELGD) mapping function may be appropriate (for example, residential mortgage exposures and HVCRE exposures).

Answer to Question 16:

We have treated this issue at length in our Overview section. However, we wish to emphasize a couple of major points. First, the U.S. treatment of LGD and ELGD would make Basel II capital comparisons across nations meaningless. Even for identical portfolios, the U.S. RWA calculation would always be above the European RWA calculation (due to the subtraction of $PD \cdot ELGD$ from loss at the confidence interval, versus subtraction of $PD \cdot LGD$ from loss at the confidence interval).

Second, U.S. agency staff has said that the use of the Supervisory Mapping Function is “all or nothing” – it may not be used for some sub-products within an asset class. This requirement runs counter to the objectives of prudential regulation intended to gain a best-practice picture of bank risk versus bank capital. In particular, it would require use of a SMF with an arbitrary “add-on” to estimates of ELGD – even if the bank had best-practice estimates of actual LGD for almost all of its sub-products within a particular asset class. And, again, use of the SMF adds significantly to compliance burden without a commensurate improvement in risk measurement and management procedures.

Question 17: The agencies seek comment on the extent to which ELGD or LGD estimates under the proposed rule would be pro-cyclical, particularly for longer-term secured exposures. The agencies also seek comment on alternative approaches to measuring ELGDs or LGDs that would address concerns regarding potential pro-cyclicality without imposing undue burden on banks.

Answer to Question 17:

First, it must be remembered that the concern over pro-cyclicality in the Pillar 1 capital regulations is highly dependent on whether the capital rules are binding – i.e., whether the regulatory capital requirements rather than internal ECap measurements drive loan pricing, credit allocation, and credit availability. Lenders using best-practice internal ECap procedures, in the absence of capital regulation, would tend to have ECap rise – to a greater or lesser extent depending on the internal rating, PD, and LGD estimation

procedures of the lender -- during economic downturns. Other things equal, such cyclicalities in ECap-estimates would also be pro-cyclical in terms of offered loan rates.

There is the risk that, to the extent the U.S. capital requirements under Basel II are *higher* than in non-U.S. countries (due to such things as the ELGD-LGD distinction, the use of higher minimum capital floors and a leverage ratio requirement, different default definitions, and removal of the SME loan lower AVCs), there will be a greater pro-cyclical effect of capital requirements in the U.S. than in other countries, because the U.S. rules would be more likely to be binding, and credit availability could perhaps be constrained.

Generally, banks favor a less prescriptive, more “principles-based” approach to specification of LGD and other risk-parameter estimates. This is consistent with the view held by the Basel Committee.¹⁶ Therefore, the non-U.S. rule, that LGDs should be determined individually by the bank -- subject to the Pillar 2 examination process -- is preferable to the U.S. use of ELGDs and the SMF. Sufficient safeguards exist – in Pillars 2 and 3, and via the multiple “floors” in the U.S. – so that the U.S. banks should not have to be burdened by the combination of 3 LGD systems (one in the U.S., another in the other Basel II countries, and a 3rd for internal best-practice purposes), let alone worrying about the possible pro-cyclical effect of the capital rules.

Question 18: The agencies seek comment on the feasibility of recognizing such pre-default changes in exposure in a way that is consistent with the safety and soundness objectives of this proposed rule. The agencies also seek comment on appropriate restrictions to place on any such recognition to ensure that the results are not counter to the objectives of this proposal to ensure adequate capital within a more risk-sensitive capital framework. In addition, the agencies seek comment on whether, for wholesale exposures, allowing ELGD and LGD to reflect anticipated future contractual pay-downs prior to default may be inconsistent with the proposed rule's imposition of a one-year floor on M (for certain types of exposures) or may lead to some double-counting of the risk-mitigating benefits of shorter maturities for exposures not subject to this floor.

Answer to Question 18:

In past responses, the RMA has noted that certain types of loan exposures – asset-based lending, for example – generally involve pay-downs of principle prior to default. The NPR's general position, however, is that EAD should not be less than current balance, even in the case of amortizing loans. However, the NPR indicates that, if appropriate, ELGDs and LGDs should be measured relative to EAD, rather than the actual amount at default.¹⁷ Thus, to the extent that estimated EAD is greater than the actual balance due at default, LGD would be lower than otherwise (since it is supposed to be measured as a ratio to EAD, not actual balance at default).

¹⁶ See “Guidance on Paragraph 468 of the Framework Document,” July 2005, BCBS.

¹⁷ “The agencies believe that actions taken prior to default to mitigate losses are an important component of a bank's overall credit risk management, and that such actions should be reflected in ELGD and LGD when banks can quantify their effectiveness in a reliable manner. In the proposed rule, this is achieved by measuring ELGD and LGD relative to the exposure's EAD (defined in the next section) as opposed to the amount actually owed at default.” Page 55849 NPR

As a practical matter, the ability of the bank to measure LGD relative to EAD (instead of relative to actual balance at default) is problematic. In particular, if the bank uses the exposure at exactly one year prior to default (to arrive at an EAD for the denominator of the LGD measurement), the resulting observation of an LGD may be too high or too low (in terms of the degree to which a troubled credit is paid-down after a credit event but before default). Additionally, the ability of the bank to use EAD rather than actual balance at default (for measuring LGD) may be limited by the supervisory guidance on LGD measurement. Indeed, the NPR states that -- “The agencies intend to limit recognition of the impact on ELGD and LGD of pre-default pay-downs to certain types of exposures where the pattern is common, measurable, and especially significant, as with various types of asset-based lending. In addition, not all pay-downs during the period prior to default warrant recognition as part of the recovery process. For example, a pre-default reduction in the outstanding amount on one exposure may simply reflect a refinancing by the obligor with the bank, with no reduction in the bank’s total exposure to the obligor.”(Page 55849)

These concerns, and the stated position in the NPR, suggest that the use of pay-downs to reduce ELGDs and LGDs will be subject to a level of prescriptiveness that may be unwarranted. Either the agencies should permit EADs to be less than current balances (where indicated by strong data), or the use of pay-downs to limit ELGDs or LGDs should be subject to a principles-based supervisory guidance (that relies primarily on Pillar 2 examination to determine when ELGDs or LGDs should be lower than the ratio of losses to actual balance at default).

Please note that we are not suggesting that the U.S. change its proposed rule in this regard, because the U.S. rule language is the same as the Basel II rules for the other countries. Rather, we suggest that the Basel Committee reconsider the general treatment of pay-downs prior to default in the context of future improvements to the Framework.

Finally, with regard to the last part of the question, we do not see where the use of data on pay-downs prior to default would be inconsistent with general safety and soundness objectives or inconsistent with the one-year floor on M for certain types of exposure.

Question 19: Questions on operational risk capital will be answered by the RMA AMA Group under separate cover.

Question 20: The agencies seek comment on the appropriateness of the 24-month and 30-day time frames for addressing the merger and acquisition transition situations advanced approaches banks may face.

Answer to Question 20:

- a. A 24-month period to implement a new plan relating to a merger or acquisition (extendable at the discretion of the supervisor for another 12 months) seems adequate. A simple, flat 3-year implementation period would be advisable to reduce uncertainty.

- b. The 30-day period after consummation of the merger to file an implementation plan is much too short. The work schedule associated with gaining approval of a merger, then consummating the merger, tends to chew up much of the same staff resources needed to develop and implement a Basel II plan and to measure risk in all parts of the bank. For this reason, the 30-day period should be extended to at least 180 days.

Question 21: The agencies are considering restating the elements of tier 1 and tier 2 capital, with any necessary conforming and technical amendments, in any final rules that are issued regarding this proposed framework so that a bank using the advanced approaches would have a single, comprehensive regulatory text that describes both the numerator and denominator of the bank's minimum risk-based capital ratios. The agencies decided not to set forth the capital elements in this proposed rule so that commenters would be able to focus attention on the parts of the risk-based capital framework that the agencies propose to amend. Commenters are encouraged to provide views on the proposed adjustments to the components of the risk-based capital numerator as described below. Commenters also may provide views on numerator-related issues that they believe would be useful to the agencies' consideration

Answer to Question 21:

- a. We do not have further comments on the calculation of RWA (the denominator of the risk-weighted capital ratios).
- b. With respect to the numerator of the risk-weighted capital ratios, we believe that placing limits on the use of tax-advantaged Trust Preferred and other hybrid equity-like instruments for Basel II banks runs counter to the objectives of prudential policy. At a minimum, the current limit of 15% for internationally active BHCs should be at least doubled, since such hybrid instruments are significantly less costly than new equity share issuances, but serve the same purpose of helping to meet the insolvency-probability soundness standard. This issue would, of course, be a matter for the full Committee to consider, unless there are currently no restrictions, or lesser restrictions, on the use of hybrid instruments in the other Basel countries.
- c. The deduction of minimum regulatory capital requirements for the insurance subsidiary (from the numerator of the capital ratio) in the U.S. is more stringent than the Framework treatment.
- d. The NPR treatment of certain capital deductions from Tier 1 – including gains-on-sale for securitizations, 50% of I/O strips in securitizations, and 50% of any negative ALLL-EL calculations – directly reduce the calculated leverage ratio.

Question 22: The agencies seek comment on the proposed ECL approach for defaulted exposures as well as on an alternative treatment, under which ECL for a defaulted exposure would be calculated as the bank's current carrying value of the exposure multiplied by the bank's best estimate of the expected economic loss rate associated with the exposure (measured

relative to the current carrying value), that would be more consistent with the proposed treatment of ECL for non-defaulted exposures. The agencies also seek comment on whether these two approaches would likely produce materially different ECL estimates for defaulted exposures. In addition, the agencies seek comment on the appropriate measure of ECL for assets held at fair value with gains and losses flowing through earnings.

Answer to Question 22:

- a. The alternative treatment would entail additional burden for the bank – since the expected economic loss would entail another calculation in addition to the accounting calculation of the portion of the ALLL due to defaulted assets. We believe that any difference between the two approaches would be small, meaning that the burden of the additional calculation is not justified. We therefore support the proposal as it is currently stated.
- b. In the case of assets “held for sale”, there is no longer any ALLL associated with the asset, because it is valued at market. Therefore, there should be no ECL associated with such assets (assuming the Pillar 2 process finds no significant deficiency in the MTM procedures of the bank).
- c. Note that, for assets moved from accrual to “held for sale” status, such a move, if resulting in a 5% or more discount, should not be treated as a default for reference database purposes for reasons discussed above -- and because such a treatment would differ from the European version of Basel II. In particular, the bank may be setting up the assets for sale for portfolio risk reduction reasons, while none of the assets may have incurred “credit events.” The market value, if lower-than-carrying-value, may be due to a variety of reasons, including market illiquidity, differences in the market’s portfolio construction from that of the seller, or differences in the general market’s appetite for risk from that of the seller.

Question 23: This approach with respect to functionally-regulated consolidated insurance underwriting subsidiaries is *different from the New Accord*, which broadly endorses a deconsolidation and deduction approach for insurance subsidiaries. The Board believes a full deconsolidation and deduction approach does not fully capture the risk in insurance underwriting subsidiaries at the consolidated BHC level and, thus, has proposed the consolidation and deduction approach described above. The *Board* seeks comment on this proposed treatment and in particular on how a minimum insurance regulatory capital proxy for tier 1 deduction purposes should be determined for insurance underwriting subsidiaries that are not subject to U.S. functional regulation.

Answer to Question 23:

The CWG is leaving treatment of this question to those members that have, or likely will have, insurance activities. We do wish to point out, however, that the U.S. treatment of insurance subsidiary assets is another example of cumulative conservatism that departs significantly from the international Framework treatment and therefore contributes to competitive inequities.

Question 24: The agencies seek comment on how to strike the appropriate balance between the enhanced risk sensitivity and marginally higher risk-based capital requirements obtained by separating HVCRE exposures from other wholesale exposures and the additional complexity the separation entails.

Answer to Question 24:

- a. In order for an ADC loan (within the commercial real estate category) to be *not* treated as HVCRE, it must meet the specific exception requirements.¹⁸ The burden of exception-identification may be very large, and, in some cases, may force the bank to treat all ADC loans as HVCRE. For example, condition (B) in footnote 17 (data on the obligor's equity contribution in relation to the "as completed" value) is often very difficult to uncover.
- b. This compliance burden could be greatly reduced, and a greater alignment of regulatory capital charges with best-practice capital charges could be achieved, if all MFL ADC loans were treated as *not* HVCRE. Further, as noted earlier, MFL loans have properties of retail mortgages in that defaults are less tied to systemic conditions than ordinary CRE loans. For this reason, not only should MFL ADC loans be not treated as HVCRE, but also, non-ADC MFL loans should have AVCs that are lower than for ordinary C&I loans.

Question 25: The agencies request comment and supporting evidence on the consistency of the proposed treatment with the underlying riskiness of SME portfolios. Further, the agencies request comment on any competitive issues that this aspect of the proposed rule may cause for U.S. banks.

Answer to Question 25:

See our response, and the cited research literature, associated with Questions 1 and 2 above. We would like to emphasize that the lower, more appropriate capital requirement for SME loans made by foreign-owned banks constitutes a competitive disadvantage for U.S. banks and, in the extreme, could reduce the flow of loanable funds to small businesses in the U.S.

Question 26: The agencies request comment on the appropriate treatment of tranching exposures to a mixed pool of financial and non-financial underlying exposures. The agencies specifically are interested in the views of commenters as to whether the requirement that all or substantially all of the underlying exposures of a securitization be financial exposures should be

¹⁸ The HVCRE category excludes "facilities used to finance (i) one-to-four-family residential properties or (ii) commercial real estate projects where: (A) The exposure's LTV ratio is less than or equal to the applicable maximum supervisory LTV ratio in the real estate lending standards of the agencies; (B) the borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised "as completed" value; and (C) the borrower contributed the amount of capital required before the bank advances funds under the credit facility, and the capital contributed by the borrower or internally generated by the project is contractually required to remain in the project throughout the life of the project." p. 55858 of NPR

softened to require only that some lesser portion of the underlying exposures be financial exposures.

Answer to Question 26:

Our major concern is that the requirement not stand in the way of the development of innovative securitization structures, especially those that including underlying positions that are “non-financial” under the regulatory definition of such assets.

We suggest that, in general, if NRSROs either 1) have established defined rating criteria for the underlying positions, or 2) have rated one or more tranches of the securitization, the Basel II bank should be permitted to use securitization treatment on the same grounds as securitization of “financial” positions. As such, the securitization treatment for pools of such “non-financial” assets could include the RBA for rated or inferred-rating tranches; the IAA for ABCP tranches; the SFA for unrated tranches; or deduction for positions that are not eligible for any of the other treatments. Examples of such “non-financial” underlying positions might include:

- Revenues from intellectual property rights
- Entertainment royalties
- Project finance revenues
- Leased equipment residuals

Question 27: The agencies seek commenters' perspectives on other loss types for which the boundary between credit and operational risk should be evaluated further (for example, with respect to losses on HELOCs).

The RMA AMA group will be providing a response to this question.

Question 28: The agencies generally seek comment on the proposed treatment of the boundaries between credit, operational, and market risk.

Almost all RMA CWG members are also members of ISDA and IIF, which will be providing a joint response to this question.

Question 29: The agencies seek comment on this approach to tranching guarantees on retail exposures and on alternative approaches that could more appropriately reflect the risk mitigating effect of such guarantees while addressing the agencies' concerns about counterparty credit risk and correlation between the credit quality of an obligor and a guarantor.

Answer to Question 29:

In general, the CWG believes the approach to tranching guarantees on individual retail exposures is appropriate and that the agencies' decision to exclude such guarantees from the securitization treatment is the correct approach. Such guarantees include private mortgage insurance (“PMI”) from highly rated insurers and government as well as private guarantees on certain student loans. Typically, the default frequency for such loans is unaffected by the guarantee, but rather the guarantee acts to effectively reduce the LGD on a defaulted loan. It is appropriate in such cases for the lender to estimate how the insurance or guarantee reduces observed LGDs, depending on the nature of the guarantee.

Banking agency concerns over the counter party credit risk associated with such guarantees can be alleviated through the Pillar 2 process, in which the lending bank should demonstrate that its internal ECap procedures take such risk into account (including the potential for any correlation between the credit quality of the guarantor and that of the obligor). We should note, however, that even the default of a guarantor in the cases of PMI or private-company guarantees of student loans would not affect the PDs of the underlying loans – the guarantor’s default would affect only the first few percentage points of loss-given-default on those loans.

Question 30: The agencies seek comment on wholesale and retail exposure types for which banks are not able to calculate PD, ELGD, and LGD and on what an appropriate risk-based capital treatment for such exposures might be.

Answer to Question 30:

- a. The 300 percent risk weight for margin loans is excessive.
 - For retail margin loans, loss data are rare because margin calls are made when the value of the underlying asset falls. The inability to measure PDs and LGDs flows from this lack of internal loss data which in turn flows from the extreme high quality of the loans.
 - In such cases, acceptable practice should be to use an aggregated internal-data approach. Such an approach, for example, might be to observe loss levels at the portfolio level which are then coupled with assumptions or data on default rates in order to “back into” LGDs.
 - Absence even such aggregated internal data, such loans should be subject to no more than the current rule (risk weight of 100%), which would still be extremely conservative.
- b. There may be other loans, including cash-secured transactions, for which quality is very high and, in the absence of internal data, one of the two methods above should be permitted.

Question 31: The agencies seek comment on the appropriateness of permitting a bank to consider prepayments when estimating M and on the feasibility and advisability of using discounted (rather than undiscounted) cash flows as the basis for estimating M.

Answer to Question 31:

- a. This is essentially a Pillar 2 issue in which excessive prescription should be avoided.¹⁹

¹⁹ However, the Framework specifically defines $M = (\sum t * CF_t) \div (\sum CF_t)$, where CF_t is the cash flow at time t. See paragraph 320, Framework, June 2004.

- b. For internal best-practice methods, M may be estimated alternative ways, depending on the exact nature of the portfolio Economic Capital methodology of the bank.
- In models in which capital is measured in relation to a distribution of changes-in-market-values, the MTM process would include the effects of expected prepayments.
 - In default-mode models, M might be measured either as a duration concept (expected cash flows with or without prepayments) or as remaining term.
- c. Note that taking into account expected prepayment reduces both M and the estimated PD, since prepaid loans cannot default. In effect, prepayments (which may be a contributor to market risk) are a “competing risk” to that of default risk. Prepayments also reduce duration. However, there is little consensus on the extent to which, if at all, prepayment expectations should reduce M.

While M would tend to be lower for banks using expected prepayments, the treatment should not be prescriptive. That is, the use of expected prepayments may be theoretically more appropriate than simple use of remaining term; but banks should be permitted to use the latter methodology to reduce calculation burden and, if so, would be subject to a more conservative capital treatment. This choice ought to be left to the bank because the incentives are in the proper direction for the bank to develop more accurate (less than remaining term) estimation procedures. Pillar 2 examinations should be the process by which the supervisor reviews the appropriateness of any method other than the remaining term.

Question 32: The agencies understand that there is a tension between the statutory risk weights provided by the RTCRRI Act and the more risk-sensitive IRB approaches to risk-based capital that are contained in this proposed rule. The agencies seek comment on whether the agencies should impose the following underwriting criteria as additional requirements for a Basel II bank to qualify for the statutory 50 percent risk weight for a particular mortgage loan: (i) That the bank has an IRB risk measurement and management system in place that assesses the PD and LGD of prospective residential mortgage exposures; and (ii) that the bank's IRB system generates a 50 percent risk weight for the loan under the IRB risk-based capital formulas.

Answer to Question 32:

The loans covered by the RTCRRI Act deal with construction loans on 1-4 family residences in which a) the loan is for construction on a pre-sold home (50% risk weight on the construction loan), or b) a pre-sold home for which the sale contract has been cancelled (100% risk weight on the construction loan).

In general, the CWG believes that, under the AIRB, all credit assets should be afforded risk-based capital calculations. This principle would call for the agencies to a) seek from

Congress removal or modification of the legislative language or b) reach an interpretation of legislative language either in the RTCRRI Act or another piece of legislation that allows the agencies to use the Basel II AIRB risk weight (for Basel II banks), whether such risk weights are higher or lower than the flat weights provided in the RTCRRI Act. Note also that the existence of the legislation, in the absence of regulatory interpretation that would be consistent with Basel II, provides for still another case in which there would be a difference between Basel II in the U.S. and in other countries – with the competitive effects discussed earlier.

If the agencies are unable to agree on a legislative course of action, or unable to convince Congress of the need for action, matters should not be compounded by requiring AIRB banks to go through another set of calculations to arrive at the risk-weights that, because of the legislation, Basel I banks will be using. This additional cost to the Basel II banks would seem to be justified only to the extent that the AIRB approach could generate credit risk capital charges that are the equivalent of higher than 50% risk weights – a highly unlikely outcome in the case of construction loans on pre-sold properties. Thus, the proposed treatment requires significant additional compliance cost which, in the absence of removing the legislation, will result in no prudential benefit to the regulatory agencies.

Question 33: The agencies seek comment on all aspects of the proposed treatment of one- to four-family residential pre-sold construction loans and multifamily residential loans.

Answer to Question 33:

The issue of appropriate AVCs is discussed in our response to Questions 1 and 2, and should be taken up by the entire Committee.

Interestingly, the recent U.S. guidance on CRE “concentrations” indicates that a numerical standard for possible “concentration” applies either to a) ADC loans or b) the total of all CRE loans in relation to capital and in relation to the recent growth rate for the institution’s CRE loans. That is, neither construction loans on pre-sold single family residences nor multifamily residential loans are singled out by the guidance. U.S. regulators clearly do not view construction loans on pre-sold residences or permanent multi-family residential loans as involving relatively high risk²⁰ -- a position with which we agree. The Basel Committee should consider the evidence in its continual review of AVCs and, accordingly, should adjust these AVCs for such loans downward. In particular, the AVCs for such loans should look more like the AVCs for residential mortgages than the AVCs for C&I loans.

Questions 34 -41: These questions dealing with counter-party credit risk will be answered via the joint response of ISDA-IIF. Essentially all RMA Capital Working Group members are also members of one or both of these other organizations.

²⁰ See “Concentrations in Commercial Real Estate Lending; Sound Risk Management Practices,” December 6, 2006, U.S. Banking Agencies.

Question 42: Accordingly, for this limited set of traditional guarantees of retail exposures by high credit quality guarantors, a bank would be allowed to recognize the benefit of the guarantee when estimating ELGD and LGD, but not when estimating PD. The agencies seek comment on this alternative approach's definition of eligible retail guarantee and treatment for eligible retail guarantees, and on whether the agencies should provide similar treatment for any other forms of wholesale credit insurance or guarantees on retail exposures, such as student loans, if the agencies adopt this approach.

Questions 43: The agencies seek comment on the types of non-eligible retail guarantees banks obtain and the extent to which banks obtain credit risk mitigation in the form of non-eligible retail guarantees.

Question 44: A second alternative that the agencies are considering for purposes of the final rule would permit a bank to recognize the credit risk mitigation benefits of all eligible guarantees (whether eligible retail guarantees or not) that cover retail exposures by adjusting its estimates of ELGD and LGD for the relevant segments, but would subject a bank's risk-based capital requirement for a segment of retail exposures that are covered by one or more non-eligible retail guarantees to a floor. Under this second alternative, the agencies could impose a floor on risk-based capital requirements of between 2 percent and 6 percent on such a segment of retail exposures. The agencies seek comment on both of these alternative approaches to guarantees that cover retail exposures. The agencies also invite comment on other possible prudential treatments for such guarantees.

Answers to Questions 42, 43, and 44:

These 3 questions deal with the treatment of guarantees for retail credits. The agencies have made two alternative proposals and seek input with regard to which proposal, or combination of proposals, or alternative proposal, to choose.

- a. The proposed treatment for “eligible” retail guarantees.
 - The proposal makes sense in that the bank may assess the effect of the guarantee (in the form of PMI from a highly rated insurer or a guarantee from a sovereign) on ELGD and LGD, but not on PD. Further, the proposal helps to reduce compliance cost. However, the definition of an “eligible” guarantee seems to be too narrow. Clarification is needed that, for example, guaranteed student loans, where a state, county, or municipality, or an agency thereof, is the guarantor, are included as “eligible.” Still other guarantees might be included within the definition of “eligible”, including guarantees such as student loan guarantees from highly-rated private organizations (e.g., those with a single A or higher rating)
 - In addition, the proposal brings up the question of the degree to which assessing and recording the credit rating of the PMI provider needs to be a continuous function of the bank. For most mortgages, for example, as the loan is amortized and as any inflation in house prices occurs, the effective LTV declines and the exposure to the insurer declines. Moreover, as the exposure declines, the insurance fee

(charged to the borrower) does not decline, further reducing risk to the insurer. We believe, therefore, that it would be sufficient to assess the eligibility of the PMI insurer only at the point at which the bank first uses a particular insurer. Such a rule would reduce the compliance burden for the bank, without leading to a significant concern regarding the counterparty risk of the guarantee.

- b. The proposed treatment for “ineligible” guarantees.

The CWG is concerned that, with respect to “ineligible” guarantees, it may prove difficult to implement a procedure in which the retail exposure is essentially converted to a wholesale exposure and then the rating of the wholesale guarantor is substituted for the rating of the obligor. Expanding the coverage of “eligible” guarantees, as recommended above, would alleviate this problem. At the same time, however, for those AIRB banks that are able to use the alternative “wholesale oriented” approach, this flexibility should be afforded them.²¹

- c. The NPR proposes a separate alternative to the treatment for retail guarantees in a. and b. above, in which the bank would adjust the ELGD and LGD of all eligible guarantees that cover retail (without regard to the rating of the insurer), but the resulting capital calculation would be subjected to a floor (in the range of 2% to 6% on the exposures).

We are opposed to such an alternative, since it harks back to the Basel I type of capital allocation and would, in general, be significantly too conservative for the treatment of such important asset classes as PMI mortgages and guaranteed student loans.

Question 45: The agencies seek comment on this differential treatment of originating banks and investing banks and on alternative mechanisms that could be employed to ensure the reliability of external and inferred ratings of non-traded securitization exposures retained by originating banks.

Answer to Question 45:

- a. The requirement for two external ratings for an originating bank, in the context of a retained, un-traded position (that is not a first-dollar position subject to deduction), is another area of difference between the U.S. proposed treatment and the international version of Basel II.
- b. We do not believe that the U.S. requirement fulfills any prudential purpose -- in particular, we do not believe that the originating bank can influence

²¹ In the treatment of guarantees for retail credits, the U.S. proposal is already somewhat more flexible than the European version of Basel II in that the U.S. version does permit either an LGD treatment (for “eligible” guarantees) or a PD substitution treatment (for “ineligible” guarantees). This distinction is warranted by the U.S. banks’ reliance on guarantees such as PMI and public or private guarantees of student loans (neither type of credit guarantees are used much in Europe).

in any manner the rating purchased from a single NRSRO for an un-traded position. That is, the NRSRO's reputation for objectivity is paramount to the NRSRO, and could not be "bought" in the context of obtaining any rating.

- c. If the regulator were at all concerned over the appropriateness of the NRSRO rating, it could require, as a matter of supervisory implementation of the Basel II AIRB approach, that the bank perform its own internal rating (employing the NRSRO procedures) as is done in the case of un-rated tranches of ABCP securitizations. The lower of the internal or external rating could be the mandated rating used for regulatory capital purposes. Any systematic deficiencies in the bank's internal rating process for a retained securitization position would be as much a focus of supervisory review as the internal rating for large corporate credits.
- d. Retained, un-traded mezzanine tranches for securitizations are not typically a large percentage of a U.S. bank's securitization activities. However, the rule requiring the purchase of two ratings would likely eliminate the use of the RBA for such un-traded positions by U.S.-regulated banks.

Question 46: The agencies seek comment on whether they should consider other bases for inferring a rating for an unrated securitization position, such as using an applicable credit rating on outstanding long-term debt of the issuer or guarantor of the securitization exposure.

Answer to Question 46:

The hierarchy of approaches discussed in the NPR is consistent with the position taken within the Framework. This issue should be discussed, however, by the Committee, in the context of future evolutions in the Basel II process. In particular, as the AIRB approach becomes mature (after the transition process in the Basel countries), consideration should be given to allowing an IAA for unrated, untraded tranches, as in the case of ABCP positions.

Question 47: The agencies seek comment on the appropriateness of basing the risk-based capital requirement for a securitization exposure under the RBA on the seniority level of the exposure.

Question 48: Under the RBA, a bank must use Table G when the securitization exposure's external rating represents a long-term credit rating or its inferred rating is based on a long-term credit rating. A bank must apply the risk weights in column 1 of Table G to the securitization exposure if the effective number of underlying exposures (N) is 6 or more and the securitization exposure is a senior securitization exposure. If the notional number of underlying exposures of a securitization is 25 or more or if all the underlying exposures are retail exposures, a bank may assume that N is 6 or more (unless the bank knows or has reason to know that N is less than 6). If the notional number of underlying exposures of a securitization is less than 25 and one or more of the underlying exposures is a non-retail exposure, the bank must compute N as described in the SFA section below. If N is 6 or more but the securitization exposure is not a senior securitization exposure, the bank must apply the risk weights in column 2 of Table G. A bank

must apply the risk weights in column 3 of Table G to the securitization exposure if N is less than 6. The agencies seek comment on how well this approach captures the most important risk factors for securitization exposures of varying degrees of seniority and granularity.

Answer to Questions 47 and 48:

The Group agrees with the general concept of basing the capital charge on seniority and granularity.

With regard to seniority there are important implementation issues. In particular, it is costly to track the seniority of a position (tranche) over time, as other tranches mature. The bank should be given the option of using Column 2 in Table G, rather than track seniority.

With regard to the calculation of N, the proposal to define N as ≥ 6 when the notional number of underlying exposures is ≥ 25 seems reasonable. However, it may prove expensive for the bank to track N over time as individual positions in the pool mature, prepay, or default. Over time, N must decline with such terminations of individual positions in the pool, but this decrease in granularity, from the point of view of overall pool risk, will be offset by an increase in age of the underlying assets – which, for some credit assets, reduces default risk. Implementation costs, therefore, would be reduced, without a necessary increase in risk, if the bank is required to determine N only at the outset of the securitization transaction. Alternatively, the bank might only have to determine N “periodically”, if N at origination is large. For example, a pool at origination with hundreds of positions would be very unlikely to reach $N < 6$ within several years.

Question 49: The agencies seek comment on suggested alternative approaches for determining the N of a re-securitization.

Answer to Question 49:

The proposed treatment of re-securitizations under the RBA seems reasonable. The treatment would mean that, in order to receive “granular” treatment under Column 2 of Table G, the notional number of positions in the underlying pool of tranches needs to be 25 or more. This treatment, while conservative, appears to be based on the notion that the AVCs between tranches of multiple securitizations are effectively higher than the AVCs between individual assets within a given tranche of a given securitization. While this notion makes intuitive sense, we cannot at this time assess the reasonableness of the capital requirements in column 2 versus column 3 in Table 3 (as applied to re-securitizations), and thus ask that the proposed treatment be reconsidered in the light of any future research on the subject.

Question 50: The agencies have not included this concept in the proposed rule but seek comment on the prevalence of eligible disruption liquidity facilities and a bank's expected use of the SFA to calculate risk-based capital requirements for such facilities.

Answer to Question 50:

Under the Framework, an eligible disruption liquidity facility for an ABCP program can be assessed capital using the SFA, under which the resulting SFA capital requirement would be multiplied by 20% to arrive at the actual regulatory capital requirement for the facility.

As indicated in the response of the American Securitization Forum, such facilities are indeed used in some U.S. ABCP programs; however, it is unlikely that a bank would use the SFA for such a position -- rather the bank would use the IAA.

However, treatment of such a position under the Standardized approach is to assign a CCF = 0, because of the extremely low probability of a draw for such a facility. Thus, even if the U.S. were to use the Framework's treatment -- by applying a 20% weight to an SFA-derived capital charge -- the bank would still likely use the IAA and, in either case, would be placed at a competitive disadvantage to the bank using the Standardized approach. It is therefore clear that the full Committee should consider revision of the Framework, perhaps increasing the CCF under the Standardized approach (zero) to an appropriately low, but non-zero CCF.

Question 51: Under the proposed rule, as noted above, a bank is not required to hold regulatory capital against the investors' interest if early amortization is solely triggered by events not related to the performance of the underlying exposures or the originating bank, such as material changes in tax laws or regulation. Under the New Accord, a bank is also not required to hold regulatory capital against the investors' interest if (i) the securitization has a replenishment structure in which the individual underlying exposures do not revolve and the early amortization ends the ability of the originating bank to add new underlying exposures to the securitization; (ii) the securitization involves revolving assets and contains early amortization features that mimic term structures (that is, where the risk of the underlying exposures does not return to the originating bank); or (iii) investors in the securitization remain fully exposed to future draws by borrowers on the underlying exposures even after the occurrence of early amortization. The agencies seek comment on the appropriateness of these additional exemptions in the U.S. markets for revolving securitizations.

Answer to Question 51:

Strictly on grounds of competitive equity, the additional exemptions within the Framework should be afforded to U.S. Basel II banks. Even if securitization transactions with these features are small in number (or non-existent) at the present time, future market conditions could lead to their introduction in the U.S., thereby mandating changes in the U.S. rules.

Question 52: The agencies solicit comment on the distinction between controlled and non-controlled early amortization provisions and on the extent to which banks use controlled early amortization provisions. The agencies also invite comment on the proposed definition of a controlled early amortization provision, including in particular the 18-month period set forth above.

Question 53: The agencies seek comment on the appropriateness of the 4.5 percent excess spread trapping point and on other types and levels of early amortization triggers used in securitizations of revolving retail exposures that should be considered by the agencies.

Question 54: The agencies seek comment on and supporting empirical analysis of the appropriateness of a more simple alternative approach that would impose at all times a flat CF on the entire investors' interest of a revolving securitization with a controlled early amortization provision, and on what an appropriate level of such a CF would be (for example, 10 or 20 percent).

Answers to Questions 52, 53, and 54:

The NPR's treatment of early amortization ("EAm") securitizations is quite punitive during any period when excess spread is only slightly above an excess spread trapping point, during a period in which excess spread is trapped, and during the rare EAm period. There are two major issues with regard to the NPR's capital treatment of EAm.

First, the conditions on page 55894 of the Federal Register version of the NPR appear to make most or all U.S. early-amortization transactions "non-controlled."

The most troublesome condition is ii): "Throughout the duration of the securitization (including the early-amortization period) there is the same pro rata sharing of interest, principal, expenses, losses, fees, recoveries, and other cash flows from the underlying exposures, based on the originating bank's and the investors' relative shares of the underlying exposures outstanding measured on a consistent monthly basis."

In U.S. deals, *principle payments* during the early-am period are shared on the pro rata basis that existed at the start of the early-amortization period. The other cash flows, including losses on defaults, are shared each month (whether before or during EAm), based on the relative shares between the seller and the investors at the start of the month. Suppose that, at start of EAm, the seller and investors share, say, 90/10 in all outstanding balances. During the first month of EAm, the flows coming *from* the securitized accounts, including principal payments, are shared on this 90/10 basis -- but the seller funds all principle additions to (good) accounts as per the early-amortization requirements.

Because the seller funds any new principle additions, at the end of the first month of EAM, the investors' percentage ownership of balances outstanding falls to below 90%. If, for example, principle payments were 10% (ignoring defaults) and new balance additions were also 10%, then the investors would hold 81% of balances at the end of the month to the seller's 19% of balances. During the second month, all cash flows, *except for principle payments*, would be shared according to the percentage ownership at the start of the 2nd month (81%/19%). However, principle payments during the second month, and during all future months, continue to be shared at the 90/10 relationship that existed prior to and at the start of EAm.

Thus, in the U.S., essentially all transactions involving an EAm feature would be classified as "non-controlling" for purposes of establishing a Credit Conversion Factor for the investors' interest in the balances on underlying accounts. In particular,

essentially all credit card securitization would be subject to the capital requirements under Table J (p. 55895).²²

In contrast, United Kingdom deals generally do not have the requirement that, during EAm, principle payments continue to be shared at the investor-seller ratio that exists at the start of EAm. Therefore, UK deals typically do not have the investors' share of outstanding principle decline as rapidly during EAm as in the U.S. deals. Other things equal, the UK deals are more likely to have an effective EAm period that exceeds 18 months, although this would depend on estimates of payment rates. Note also that UK deals typically are not treated as securitizations for GAAP purposes, only for regulatory purposes.

Second, we believe a) these CCFs (for both controlled and non-controlled EAm transactions) are too punitive; b) coupled with the NPR's maximum securitization capital requirements, the CCFs create disincentives to securitize credit card balances – even though such securitizations do transfer significant amounts of credit risk to investors, throughout the complete range of excess spreads (and during the Early Amortization period).

Neither the controlled nor non-controlled CCFs, in Tables I and J, are as low as analytical estimates indicate.²³ However, the CCFs associated with non-controlled status are clearly punitive.

Significant credit risk is transferred from the seller to investors in “non-controlled” transactions – during an EAm occurrence.²⁴ We have made calculations that show how much in the way of credit losses the investors would absorb if a “tail-event” occurs at any point – when excess spread is above the trapping point, below the trapping point, or during an EAm occurrence (negative excess spread). No matter where the bank is (in terms of a tail-event that occurs before, during, or after the trapping of excess spreads), the CCF should be set so that it reflects the amount of losses absorbed by the investors rather than the seller. These CCFs are shown in Table 1 below:

²² Note that Conditions iii) and iv) in the NPR may also be interpreted as invoking “non-controlled” status for U.S. credit card securitizations. Also, condition iv) differs from the Framework version in that the U.S. proposal calls for the (“effective”) amortization period during EAm to be no faster than the equivalent of 18 months straight line. At recent principle payment rates, this condition would not be satisfied in most U.S. deals.

²³ We also seek clarification as to whether, in the case of “controlled” Early Amortization structures, the CCF rises to 100% or remains at 40% in the event that excess spread turns negative and EAm is triggered. As discussed below, the economics suggests that the CCF should *never* rise to 100% in either controlled or non-controlled securitization transactions.

²⁴ Also, in some transactions, interest rate risk clearly dominates such credit risk. For example, if the special purpose vehicle's liabilities are all fixed rate, then excess spread could turn negative due to a significant decline in interest rates.

Table 1 – Effective Credit Conversion Factors for Investors’ Interests in a “Non-Controlled” Early Amortization Securitization

Column 1	2	3	4	5	6
		Weighted Avg. CCF at various payment speeds			Table J
excess spread	months to EAm	20.00%	15.00%	10.00%	
6.00%	16.5	0	0	0	0
4.50%	9.3	3.62%	2.49%	1.37%	5%
3.38%	5.2	29.82%	22.51%	14.07%	15%
2.25%	2.3	53.93%	46.53%	31.95%	50%
1.10%	0.6	68.92%	61.61%	46.77%	100%
0.00%	0.0	72.17%	64.51%	48.97%	100%

Appendix 2 describes the conservative assumptions underlying the CCF calculations in Table 1. Note that the effective CCFs shown in the table differ according to the assumption one uses regarding the rate at which account holders pay off principal of the securitized accounts (the monthly “payment speed” is the percentage of balance at the beginning of the month paid off during the month). If the tail event starts exactly at the point of excess spread already having reached zero (the start of EAm), Column 3 shows that the effective CCF would be 72.17% if we assume that principal payments occur at the rate of 20% per month. Such a principal payment rate is similar to what occurs during a good time in the cycle (e.g., 2006-2007), whereas during a downturn the principal payment rate should decline. Column 4 shows that the effective CCF would be less than 65% at a principal payment rate of 15% per month. Compare these CCFs with the ones in the NPR as shown in Table J for “non-controlled” early amortizations.

The high CCFs in Table J, when coupled with the capital deduction for credit-enhancing I/O strips, means that the capital requirement for securitized card balances can be greater than that for the underlying assets if they were not securitized – if the bank gets to the point of being near or in EAm. Indeed, in the U.S. version of the securitization rules, the condition for invoking the “limit” to securitization capital requirements is more stringent than in the Framework.

In particular, in the Framework, the securitization capital requirement (for all positions of the originating-selling bank) is limited to the RWA capital requirement for the underlying, plus the Gain-on-sale and any other portion of the I/O strip. In the U.S. proposal, the limit on securitization capital requirements is the RWA capital requirement for the underlying *plus the ECL for the underlying*, plus the capital deduction for the gain-on-sale and I/O strip.²⁵

²⁵ Note that the treatment of bank “positions related to securitization” is critical to determination of the degree of stringency of the U.S. and Framework rules. In the U.S., there remains no clear guidance on the degree to which, for purposes of computing the “cap” on securitization capital, various other securitization positions besides the I/O strip will be deemed to be credit-enhancing positions. These positions include a) accrued interest and fees; b) accrued servicing fee; c) cash reserve account or collateral invested amount; d) “other” securitization positions.

Such a stringent condition means that, as the excess spread is driven down close to the EAm point, the securitizing bank will have to hold more capital than the bank that has not securitized the assets, even though, as shown in the calculations above, the investors will be absorbing significant credit losses in the event of EAm – whereas the originating bank will absorb *all of the credit losses* in the case of no securitization.

We believe that the only ways to fix this significant disincentive to true risk-transference are a) to make the CCF significantly less than 100% during the EAm period (and pre-EAm period) for “non-controlled” transactions or, equivalently b) to change the definition of “non-controlled” to make the U.S. transactions come under the CCFs in Table I of the NPR.

We do not support an alternative such as using a Basel-I-type arbitrary constant CCF (of 10% or 20%) for all early amortization securitizations regardless of the current level of excess spread over the trapping point. Finally, the use of a 4.5% trapping point (for purposes of using Tables I and J) in securitizations that do not use the 3-month average excess spread as the key to trapping sounds reasonable – assuming that the agencies consider our concerns with respect to the CCFs in Tables I and J. If, on the other hand, the securitization involves no trapping prior to early amortization, then the CCF should be zero prior to EAm and should look like the CCFs we show in the last line of Table 1 above in the event of EAm.

Questions 55-59 (following) deal with the capital treatment of equity positions.
Answers to Questions 55 through 59 are preceded by an overview discussion.

Overview of equity treatment issues

The proposed rules for equity exposures will result in an increase in capital relative to existing U.S. rules for two reasons: (1) a broader definition of equity and (2) increased capital requirements for equity exposures in excess of 10% of regulatory capital. We support the new, broader definition of equity based on the economic substance of the instrument.

Under current risk-based capital rules for non-financial equity, capital requirements are increased at two different threshold levels: 15% and 25% of Tier 1 capital. Our analysis indicates that the proposed single threshold of 10% of Tier 1 plus Tier 2 risk-based capital is more conservative than the current 15% of Tier 1 threshold.²⁶

Under the proposed simple risk weight approach (SRWA), incremental equity exposure above the 10% threshold would be risk weighted at 300% and 400% for publicly and non-publicly traded equity, respectively. For firms exceeding the 10% capital threshold, the new capital requirements under the SWRA approach will be substantially higher than under current rules.

²⁶ Based on recent Y-9C data, the current 15% Tier 1 threshold is roughly equivalent to a 12% Basel II Tier 1 plus Tier 2 capital threshold.

As an alternative to the SWRA approach, firms can, under the NPR, develop an internal model approach (IMA) subject to separate written supervisory approval. The proposed floors for IMA, however, will discourage use of the IMA. Additionally, the NPR indicates that the IMA floors apply to equity positions below the 10% of total capital threshold as well as to positions above the threshold. No Basel II bank would be likely to adopt the IMA under these conditions.

While the NPR market-based approaches appear to be directionally more risk sensitive, we have some concerns, namely,

- a. Hedge funds are not explicitly mentioned as coming within the scope of equity exposure treatment.
- b. Any holdings in investment funds that would otherwise be risk weighted in excess of 400% would receive a 1250% risk weight.
- c. The effectively hedged portion of a hedge pair is risk-weighted 100%.

Each of these issues is discussed below.

- a. Hedge funds and other investment funds with material liabilities.

In the NPR, investment funds “with material liabilities” are excluded from investment fund treatment, but it is not clear how such funds should be treated. Our expectation is that such funds would be addressed within the equity exposure framework.²⁷ We acknowledge the agencies’ concern related to fund leverage, and that an appropriate risk weight might exceed 400% (the weight for non-publicly traded equity) in order to appropriately take leverage into account.

We are strongly opposed to the alternative view suggested by regulatory staff in conversations with the industry, that positions in funds with liabilities be treated as a first-dollar loss position in a securitization, resulting in a capital deduction.

We believe securitization treatment is not appropriate for such investment funds. In the extreme, this interpretation could be extended to a publicly traded stock which, by this reasoning, is a first loss tranche. This interpretation would create inconsistent risk weighting by requiring a capital deduction for investment funds while private equity is subject to a ceiling risk-weight ratio of 400%. We do not see sufficient justification to conclude that all such investment funds are over 3 times riskier than private equity.

The agencies have not provided a rationale in the NPR for such a broad application of securitization treatment. Our concern is heightened as every definition of an exposure category is conditioned by the phrase “unless it is a securitization exposure”. We strongly oppose a structure in which securitization treatment is a *de facto* fall-back treatment for exposures not explicitly treated elsewhere.

²⁷ Our interpretation is based on Part VI, Section 51, p.55943 of the NPR. “To calculate its risk weighted asset amounts for equity exposures that are not equity exposures to investment funds, a [bank] may apply either the Simple Risk Weight Approach (SRWA) in section 52 or, if it qualifies to do so, the Internal Models Approach (IMA) in section 53.”

The above treatment applies specifically to hedge funds, which are investment funds with material liabilities. We oppose securitization treatment for hedge funds, for the reasons stated above, and believe hedge funds should explicitly be treated under the rules for equity exposures.

b. Risk-weights for investment funds.

Under the “modified look-through” approaches for investment funds, any exposure class that would require a risk weight in excess of 400%, if it were a direct exposure of the bank, would be assigned a risk weight of 1250%. We believe there is a need for more granular risk weights between 400% and 1250% under the look-through approaches. We also request the agencies clarify and provide examples of the types of investments fund holdings that would fall into the 1250% exposure class.

We note also that a 1250% risk weight can be more punitive than a capital deduction, for a bank subject to the “well-capitalized” requirements.²⁸ This comment also applies to other parts of the NPR that require very high risk weights.²⁹

c. Risk-weight for effectively hedged portions of hedge pairs.

The effectively hedged portion of a hedge pair entails negligible risk and additionally must meet proposed documentation standards and regulatory tests to demonstrate this fact. Therefore, we propose that, under the simple risk weight approach, the risk weight for a hedge pair should be set at zero, or, at the most, no more than the 7% risk-weight floor for investment funds, as opposed to the 100% risk weight proposed in the NPR.

Question 55: The proposed rule defines a publicly traded equity exposure as an equity exposure traded on (i) any exchange registered with the SEC as a national securities exchange under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) or (ii) any non-U.S.-based securities exchange that is registered with, or approved by, a national securities regulatory authority, provided that there is a liquid, two-way market for the exposure (that is, there are enough bona fide offers to buy and sell so that a sales price reasonably related to the last sales price or current bona fide competitive bid and offer quotations can be determined promptly and a trade can be settled at such a price within five business days). The agencies seek comment on this definition.

Answer to Question 55:

²⁸ The effect of the 1250% risk weight is identical to a capital deduction only if the bank holds exactly 8% total capital prior to the deduction. In the U.S., for example, banks must hold 10% total capital ratios to be considered “well-capitalized” – a requirement that is tantamount to a minimum capital requirement. For a bank holding exactly 10% total capital, a 1000% risk weight would have the same effect on the total capital ratio as a capital deduction (50% from tier 1 and 50% from tier 2). However, there still would be a disproportionate impact on the resulting tier 1 ratio of a 1000% risk weight compared to a capital deduction – an appendix explains this issue. The upshot is that a capital deduction should be applied rather than the 1250% risk weight. Alternatively, a risk weight of between approximately 833% and 1000% would be much more comparable to a capital deduction. See Appendix 3.

²⁹ See, for example, Table F: Risk Weights for Unsettled DVP and PVP Transactions on p. 55880 of NPR.

The Accord defines a publicly traded holding more simply than the U.S. proposal -- as any equity security traded on a recognized security exchange. For non-U.S.-based securities exchanges, we believe registration or approval by the national securities regulatory authority should suffice for this definition. We consider this a minor technical point as the expectation is that such national approval would normally be predicated on meeting the two-way market and settlement requirements.

Question 56: The agencies seek comment on the approach to adjusted carrying value for the off-balance sheet component of equity exposures and on alternative approaches that may better capture the market risk of such exposures.

Answer to Question 56:

The adjustment to carrying value is an appropriate recognition of the adjustment to regulatory capital to exclude gains on AFFS equity securities.

Question 57: The agencies seek comment on the proposed rule's requirements for IMA qualification, including in particular the proposed rule's use of a 99.0 percent, quarterly returns standard.

Answer to Question 57:

The NPR requirements limiting use of the IMA are too restrictive. A bank must choose either the internal model approach (IMA) for all equity exposures or the IMA approach for all publicly traded equity exposures and the SRWA for non-publicly traded equity exposures.

We propose that firms should be permitted to develop IMA approaches for any subset of its equity exposures, provided these choices are consistent with internal risk management practices and are approved by supervisors.

Question 58: The agencies seek comment on the operational aspects of these floor calculations (for the IMA approach).

Answer to Question 58:

While the floors discourage the adoption of the IMA approach for portfolios with significantly reduced risk due to diversification, the requirement to apply risk weighting at the aggregate level, rather than individually, appears to be operationally straightforward, and conceptually appropriate.

Question 59: The proposed rule defines an investment fund as a company all or substantially all of the assets of which are financial assets and which has no material liabilities. The agencies have proposed a separate treatment for equity exposures to an investment fund to prevent banks from arbitraging the proposed rule's high risk-based capital requirements for certain high-risk exposures and to ensure that banks do not receive a punitive risk-based capital requirement for equity exposures to investment funds that hold only low-risk assets. The agencies seek comment on the necessity and appropriateness of the separate treatment for equity exposures to

investment funds and the three approaches in the proposed rule. The agencies also seek comment on the proposed definition of an investment fund.

Answer to Question 59:

The different options for equity investment funds are an appropriate way to allow for variation in the level of detail across investment funds. According to the NPR, a bank using the full look-through approach should calculate capital as if the assets are held directly by the bank. One way of accomplishing this is to include the positions of an investment fund, after adjustment for proportional ownership, in the bank's IMA model. We see no logical reason that a bank should be precluded from using a sophisticated and risk sensitive IMA approach when the position data for investment funds is available. Accordingly, the agencies should allow either IMA or SWRA treatments in the full look-through approach.

See earlier comments on the definition and treatment of investment funds. We also seek clarification as to whether Table L can be used in connection with the full look-through approach, versus an alternative interpretation that the full look-through approach requires risk weighting the component exposures as they would be weighted if they were directly held on the balance sheet. We also request clarification on whether the 7% risk-weighting floor on investment funds is applied on a fund by fund level.

Also, investment funds that represent assets related to insurance activities should be excluded from risk weighting, as insurance capital requirements address this risk.

Question 60: Answers to questions involving operational risk capital are provided by the RMA's AMA Group under separate cover.

Question 61: The agencies seek commenters' views on all of the elements proposed to be captured through the public disclosure requirements. In particular, the agencies seek comment on the extent to which the proposed disclosures balance providing market participants with sufficient information to appropriately assess the capital strength of individual institutions, fostering comparability from bank to bank, and reducing burden on the banks that are reporting the information.

Question 62: Comments on regulatory reporting issues may be submitted in response to this NPR as well as through the regulatory reporting request for comment noted above.

Answers to Question 61 and Question 62:

- a. The disclosures associated with the new Market Risk Amendment ("MRA") should be timed to coincide with the disclosures associated with Basel II. More to the point, the January 2008 beginning of disclosures under the MRA (under Basel I) is inappropriate given that this rule has not been finalized in the U.S., is lacking published supervisory guidance, and in the rest of the Basel community, will require public disclosure only after the end of the parallel reporting period.

- b. The concerns outlined in the U.S. Basel II NPR Question 61 are not sufficiently exhaustive. We believe that any public disclosure policy should have as its aims:
 - o To provide information that will help assess bank soundness;
 - o To guard against the release of proprietary information or other information the release of which could harm the bank's competitive position;
 - o To provide for comparability across reporting institutions;
 - o To provide for fairness in the required reporting of financial information for regulated banks, investment companies, and other non-regulated publicly traded financial companies; and
 - o To maintain at a reasonable level the burden of report preparation.
- c. The disclosure requirements in the U.S. NPR are essentially the same as in the Framework except for
 - 1) Requiring the reports on a quarterly basis (in the U.S.) versus on a semi-annual basis in the rest of the Basel II countries. We do not believe that quarterly reporting of much of the required information will impart additional useful information, since much of the disclosure involves estimation that is necessarily imprecise.
 - 2) Certain of the U.S.-required disclosures will not be replicated in the European implementation of Basel II, because of the series of differences between the U.S. proposal and that of the rest of the Basel II community – e.g., the reporting of LGD vs. ELGD, and the resulting differences in RWA. Indeed, absent some very high degree of sophistication regarding the differences in the two sets of Basel II requirements, a reader could easily be misled as to the relative soundness of a particular U.S. bank and a European bank with an identical overall portfolio construction.
- d. Because of these significant differences between the U.S. Basel II proposal and the Framework, disclosures in the U.S. will continue to be a headache for the U.S. agencies and the disclosing banks:
 - o During the floor periods, the calculation of the floor-based Tier 1 ratios will be calculated differently between the U.S. and the other Basel countries. Under the Accord, expected credit losses were excluded from the RWA denominator and subtracted from general provisions in Tier 2 capital. However, the U.S. floor does not exclude expected loss in the denominator of capital ratio calculations. As a result, the top 7 or so U.S. BHCs will have floor-based Tier 1 to RWA ratios that are almost one percentage point lower than under the Framework's methodology (assuming an identical portfolio of the same size

evaluated using identical PDs, LGDs, and EADs under the U.S. versus Framework approaches).

- o Even after the floor periods, the Tier 1 ratios will continue to be calculated differently between U.S. AIRB banks and U.S. Basel I or Standardized banks.
- e. The certification requirements for the disclosures (CFO sign-off) are not unreasonable, but we are concerned over how anyone can “certify” information consisting of risk-parameter *estimates* or validation procedures for such estimates.
- f. The degree of public disclosure required within the Basel II proposal differs from the degree of public disclosure (versus confidential treatment) associated with the proposed Call Reports and Y-9 reports embedded within the U.S. Basel II rule. Frankly, we think the disclosure requirements of Basel II need much the same testing and gradual introduction as the capital calculations themselves. Consensus does not exist on the acceptable manner in which each of the requirements of Tables 11.1 through 11.10 should be met, nor are we privy at this writing to the detail of making some of the necessary calculations. We strongly suggest that the U.S. agencies require only a portion of the information discussed in the 10 Tables to be publicly disclosed, with a gradual phase-in of the additional information after some consensus is reached among the agencies, the rating agencies, the accounting profession, and the affected institutions.
- g. The timing of the release of the supervisory guidances is especially troublesome – as matter stand, we cannot even budget for the resources needed to compute certain Basel II numbers, let alone budget for the reporting processes for these Basel II calculations.
- h. The requirements for disclosing actually realized versus estimated loss parameters (e.g., realized default frequencies versus PDs) are quite problematic:
 - 1) There is no widely accepted basis on which to determine that estimated PDs are too high or too low relative to observed default frequencies in each period going forward (the previous supervisory guidance was silent on this subject) and comparability across reporting banks would be impossible to obtain without such agreement.
 - 2) Volatility in realized risk parameters such as default frequencies are the norm, both over the cycle and across portfolios in different institutions. Benchmarks for such volatilities do not readily exist for most credit products, since reported accounting measures such as net-charge-offs do not capture the same default rate and economic loss rates associated with Basel II calculations.

- 3) We therefore think that these “disclosures” (especially in Table 11.5, part d)) will serve to confuse readers rather than aid in the stakeholders’ determination of bank soundness.
- i. We seek clarification of the requirement for disclosing “non-qualification” (Section 23, part c. of the proposed regulations). While we understand the need to bring once-qualified institutions back into compliance, we are not clear on the disclosure requirements for what might be considered initial approval. In particular,
- Page 55925 of the NPR indicates that “a bank that is subject to this...NPR...and has conducted a satisfactory parallel run (then) fails to comply with the qualification requirements in Section 22” will be notified in writing of its failure to comply and must disclose this fact. Since the parallel period can be (as can be the transition periods) of any length, not just a single year, we don’t understand this paragraph.
 - More to the point, we seek clarification that i) a bank must have permission to start the parallel reporting period and that such permission would not be granted unless the relevant agencies have, in effect, signed off on the bank’s processes for calculating Basel II capital requirements; ii) the parallel reporting period could take longer than one year if the bank’s supervisors detect difficulties associated with compliance that were not observed prior to the start of the parallel reporting period. No matter the length of the parallel reporting period, the bank should have to report only when it becomes approved for the beginning of the first of the transition periods, the beginning of the 2nd transition period, and so on. Otherwise, there appears to be some unstated “norm” associated with a one-year parallel-reporting period, a one-year first transition period, and so on.
 - Also, opt-in banks may have a natural advantage over mandatory institutions in that, as we interpret the rules, the mandatory institution has up to 3 years -- from the inception of the rule (the formal starting period of Basel II in the U.S.) -- to gain approval to start its first floor period. An opt-in bank has essentially an unlimited number of years to reach the point of being qualified to begin the parallel reporting period (unless the bank becomes subject to the size criteria defining a mandatory bank). We seek clarification of this condition and note that the approval process is a relatively subjective process that may have a differential impact across several mandatory banks, depending on the specific make-up of the examination teams charged with determining Basel II qualification. Because of these

uncertainties, we recommend that the agencies permit start of the parallel periods with less than “full” qualification, so that, for example, a mandatory or opt-in bank may be permitted to apply Basel I standards to some portions of its overall risk positions that are not, at the start of the parallel period, ready to receive qualification approval.

Appendix 1

Response to the overview questions posed in the Basle IA NPR

This response of the RMA Capital Working Group refers to Questions 19 through 22 in the Basel IA proposal.

Question 19: To what extent should the Agencies consider allowing Basel II banking organizations the option to calculate their risk based capital requirements using approaches other than the Advanced Internal Ratings Based (A-IRB) approach for credit risk and the Advanced Measurement Approach (AMA) for operational risk? What would be the appropriate length of time for such an option?

Question 20: If Basel II banking organizations are provided the option to use alternatives to the advanced approaches, would either this Basel IA proposal or the standardized approach in Basel II be a suitable basis for a regulatory capital framework for credit risk for those organizations? What modifications would make either of these proposals more appropriate for use by large complex banking organizations? For example, what approaches should be considered for derivatives and other capital markets transactions, unsettled trades, equity exposures, and other significant risks and exposures typical of Basel II banking organizations?

Question 21: The risk weights in this Basel IA proposal were designed with the assumption that there would be no accompanying capital charge for operational risk. Basel II, however, requires banking organizations to calculate capital requirements for exposure to both credit risk and operational risk. If the Agencies were to proceed with a rulemaking for a U.S. version of a standardized approach for credit risk, should operational risk be addressed using one of the three methods set forth in Basel II?

Question 22: What additional requirements should the Agencies consider to encourage Basel II banking organizations to enhance their risk management practices or their financial disclosures, if they are provided the option to use alternatives to the advanced approaches of the Basel II NPR?

Answers to Questions 19-22:

The RMA Capital Working Group believes that all banking institutions should be given the option of using any of the three Basel II frameworks – Standardized, Foundation IRB, and Advanced IRB -- since these options are available to banks of all sizes in the other Basel II countries. This is simply a matter of fairness.

If, on the other hand, the U.S. were to continue to insist on making certain U.S. institutions “mandatory” banks (banks that must use the AIRB and AMA procedures), then a) all other U.S. banks should be permitted, at a minimum, to use the Basel II Standardized or Foundation IRB approach, and b) the mandatory institutions should be permitted to apply the Standardized approach to at least a portion of their activities during the parallel reporting period and the transition periods.

In the case of the U.S. mandatory and opt-in institutions -- as we have discussed at length in our response to the NPR of Basel II -- there have been very significant costs associated with the uncertainties over exactly how the U.S. versions of the AIRB approach and the AMA would be implemented. While all the mandatory institutions and many of the

potential opt-in banks have progressed well along toward final qualification, the important “finishing touches” cannot be applied until the U.S. agencies finalize the actual rule and the implementation guidance for banks and supervisors. Already, some institutions have been forced to do things twice during the several years’ delay in the U.S. implementation of Basel II. We urge the agencies to complete this process as soon as possible, given that significant competitive inequities now exist between, on the one hand, the U.S. mandatory and opt-in institutions, and on the other hand, the foreign-domiciled banks that compete with the U.S. banks in this country and abroad. We especially urge the U.S. agencies to resolve the continuing inter-agency disagreements over basic issues – such as “floors”, leverage ratios, and other items that are purported to help meet important prudential objectives such as maintaining a minimum level of soundness in our nation’s banks. As we have discussed at length in our response to the NPR, such simple ratio floors are, if anything, counter-productive in establishing and meeting social prudential objectives (they may actually *encourage* more risk taking) and, in the worst case, hurt the ability of U.S. regulated banks to satisfy the needs of low-risk borrowers.

The most effective way to speed implementation of the AIRB/AMA procedures for U.S. mandatory and opt-in institutions is to provide all such institutions with the flexibility necessary to finalize data and risk measurement requirements for a) operational risk capital, and b) portions of the banks’ credit portfolios for which sufficient internal and/or external data do not exist to compute the necessary Basel II AIRB risk parameters (PDs, ELGDs, LGDs, and EADs).

There are still major uncertainties surrounding implementation of Basel II risk metrics in these arenas. For example, the comment period on the new Supervisory Guidance is open until May 29, 2007, and has not yet been fully analyzed by industry participants and other observers as of the time of this writing. While these on-going uncertainties are being resolved by the agencies, in consultation with the industry, we believe that a number of U.S. banks could start the parallel reporting period, and even the transition periods, prior to a truly final set of implementation procedures. In effect, the data collection and measurement issues could be worked out in the somewhat longer run, while, over the transition periods, the banks would use conservative operational risk capital measurements and/or conservative credit risk parameter estimates for the small portions of their credit portfolios for which such additional time is needed. For example, the simple Basel II operational risk capital measurements already in use in the other Basel II countries – the Basic Indicator and Standardized approaches – could be used, on a case-by-case basis, in the U.S. for mandatory and opt-in banks during a period of years. This should not be objectionable to U.S. regulators since the Basic Indicator and Standardized op risk approaches should generally produce a higher capital charge than the AMA for op risk.

Similarly, the kinds of credit sub-portfolios for which there may be inadequate default and loss data are those in which historical losses have been few (i.e., very safe sub-portfolios). Use of the Standardized approach should suffice in these cases – that is, an 8% capital charge should be extremely conservative.

With respect to a new version of Basel I for the vast majority of U.S. banks, we see no compelling reason for the U.S. to deviate from the Standardized and Foundation IRB approaches now being used by the other Basel II countries. Further, while the Standardized and Foundation IRB approaches must be vetted through another ANPR and NPR, as indicated by the recent GAO report,³⁰ we do not see the need to tie this process to the process of completing the final AIRB/AMA rule for the mandatory or opt-in U.S. banks. Nor do we see the need, at any point in the transition period(s), to set floors for the AIRB/AMA approach with respect to these additional approaches (as opposed to simply using the Basel I standard now routinely computed by all U.S. banks). The U.S. mandatory and opt-in AIRB banks should not have to bear the extreme burden of calculating capital several ways – under the new Basel II approach, under the old Basel I approach, under some new Basel IA or Standardized approach, and under best-practice internal Economic Capital procedures.

With respect to Question 20, we believe that there should be enough of value in the AIRB/AMA approaches that many banks should desire to eventually opt-in. Indeed, we are aware of a number of institutions that would move to the Foundation IRB were it available in the U.S. For the vast majority of U.S. banks, however, the Standardized approach should suffice for a very long time. Regulators' concerns over such banks' activities in capital markets, the use of derivatives, equity positions, etc., can reasonably be treated under Pillar 2 – the day to day process of bank supervision which we continue to believe, in the U.S., is the best in the world.

Additionally, the U.S. can continue to subject Standardized and Foundation IRB banks to the current U.S. rules for securitization activities, and should, as well, make sure that the U.S. version of the Standardized approach involves an op risk capital charge (as is the case in the other Basel II countries). Such an op risk charge should be included because it is the right thing to do. Specifically, operational risk can be important, while failure to include such a charge would cause some regulators to push for inappropriately high credit risk capital charges which, in turn, could distort the appropriate flow of loanable funds to obligors based on realistic measurements of credit risk.

Conversely, any attempt to force major discrepancies between the U.S. Standardized approach and the Standardized approach in use in the other Basel II countries would lead to, at a minimum, additional delays and gaps in fairness, and, at a maximum, might be simply unworkable or hugely expensive for the vast majority of U.S. banks. We see no reason why the Standardized approach, already in effect in other Basel II countries, cannot be made to work in this country with timeliness and without undue cost.

³⁰ “RISK-BASED CAPITAL -- Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework,” GAO, February 2007, p9.

Appendix 2

Calculations of Credit Conversion Factors for Early Amortization Securitizations

The calculations shown in Table 1 in the text assume that the bank does not have the ability to increase interest rate margins during a tail event; does not have the ability to garner higher fees (on past-due but otherwise performing accounts); and does not benefit from the expected decline in principal payments during the tail event. The calculations show the CCF that would be appropriate in terms of the losses absorbed by the seller during the next 12 months, versus those losses absorbed by the investors, in a tail event scenario. Further, the calculations are made under the assumptions that

- a. The tail-event default rate is that computed by Basel II's credit risk formula, given today's PDs and LGDs – a tail default rate of approximately 7.9 percent (higher than the historically highest default rate of approximately 7.1 percent seen during the end of 2005).
- b. The principle repayment rates are as high as they are during recently observed, historically high-default periods (during the 2004-mid 2006 period, when neither spread trapping nor EAm was in evidence).
- c. The AVC used in the Basel II credit risk model for Qualifying Revolving Exposures (QRE) is “correct” (although the industry believe actual AVCs are on the order of one-half the Basel II AVC of 4%).

Under these assumptions, the calculations shown in Table 1 are derived by, first, measuring the economic losses associated with the tail event. These losses are then apportioned between the seller and the investor according to the terms of a typical securitization in which the investors' interest is 85% of the total balances outstanding and the seller's interest is 15%, prior to the start of any EAm period. The calculations are made assuming that economic conditions have already been sufficiently severe to push excess spread down to one of the levels shown in the Table -- then the tail event hits and losses are tracked over each of the next 12 months. Note that investors' future losses during any EAm event are shielded somewhat by the trapping of excess spread, but such shielding is incomplete. Note also that, during the spread trapping period, the bank's I/O strip is marked down to market with an accompanying loss taking down the 100% capital attributed to the I/O strip. Then, at the start of the EAm period, the only additional losses to the bank are those associated with its seller's interest in account holder balances and whatever additional losses it must incur associated with the investors' interest.

In the worst case for the seller, the tail event hits precisely at the point when excess spread has already been driven down to zero, triggering the EAm process. As the Table shows, when such an event happens, the bank (“seller”) incurs losses during the EAm period (over and above the losses allocated to the seller's own interest) equal to no more

than about 75% of the losses that would have otherwise been attributable to the investor. Using more realistic principal payment assumptions, this additional loss to the seller could be as low as approximately 50% of the losses that would otherwise have been attributable to the investors.

Appendix 3

Comparing a 1250% Risk-Weight to a Capital Deduction

In these calculations we show that use of a 1250% risk-weight for positions that are assessed “100% capital” is much more punitive than deduction treatment of such assets. In order for the impact on Total Capital to be made equivalent (between the risk-weighting method and the capital deduction method) the risk-weight should be 1000%, not 1250%. Even with this lower risk-weighting approach, the capital deduction method is less punitive, because it involves a lower necessary increase in Tier 1 relative to Tier 2.

In the calculations below, it is assumed that the bank must meet a 10% Total Capital to RWA target (for well-capitalized purposes in the U.S., or, in other jurisdictions, to maintain a cushion over the Basel minimum). It is also assumed that the bank must meet a 6% Tier 1 to RWA ratio (to be well-capitalized in the U.S. or, in other jurisdictions, to maintain a cushion over the Basel minimum.)

1. Use of 1250% risk weight.

Original balance sheet:

<u>Total RWA</u>	<u>Total Liabilities and Equity</u>	
1000	900	Liabilities
	60	Tier 1
	40	Tier 2

Assume all assets have 100% risk weights. The bank has a 10% Total Capital to RWA ratio and a 6% Tier 1 to RWA ratio under well-capitalized standards.

The bank now adds \$1 of an asset that requires a 1250% risk-weighting:

<u>Total RWA</u>	<u>Total Liabilities and Equity</u>	
1012.5 ³¹	899.75 ³²	
	60.75	Tier 1
	40.50	Tier 2

\$1.25 more is needed in Total Capital to maintain exactly the 10% TC to RWA ratio and the 6% Tier 1 ratio – 0.75 more in Tier 1 and 0.50 more in Tier 2. *That is, the capital requirement effectively exceeds 100%.*

³¹ Note that accounting assets only rise by \$1 but RWA rise by \$12.50.

³² Note that liabilities may decline by 0.25 because in accounting terms, assets go up by \$1 but Tier 1 plus Tier 2 goes up by \$1.25 to maintain the 10% Total Capital to RWA ratio.

2. Use of 1000% risk weight.

<u>Total RWA</u>	<u>Total Liabilities and Equity</u>
1010	900
	60.6
	40.4

\$1.00 more is needed in Total Capital to maintain exactly the 10% TC to RWA ratio. Since accounting assets rise by \$1 (not \$10), there is no change in liabilities. The first method – the 1250% risk-weight – requires **25%** more additional equity than the 1000% risk-weight. In the next section, we show that the 1000% risk-weight has dissimilar effects on Total Capital and Tier 1 requirements than a deduction from capital.

3. Use of the deduction method (50% from Tier 1 and 50% from Tier 2). Note that in the deduction method, the asset also is deducted from RWA.

	[After capital deduction; before capital addition]
<u>Total RWA</u>	<u>Total Liabilities and Equity</u>
1000	900
	59.5
	39.5

In order to meet the 10% TC to RWA target, as well as the 6% Tier 1 target, the bank must add \$0.5 of Tier 1 and \$0.5 of Tier 2 capital for a total of \$1 of new capital. When compared with the 1000% risk-weighting methodology, however, this involves *less* of an increase in Tier 1 (\$0.5 vs. \$0.6) and relatively *more* of an increase in Tier 2 (\$0.5 vs. \$0.4). Thus, the deduction process remains less punitive to the bank than the 1000% risk-weighting process. See method 4 below.

- 4. Calculations with the 6% Tier 1 ratio being used to determine how much of risk-weight is needed to equalize the effect of the high risk-weight with that of a capital deduction.** The result is approximately an 833% risk weight.

[After application of the 833% risk-weight to the additional \$1 asset; and after adding the extra capital.]

<u>Total RWA</u>	<u>Total Liabilities and Equity</u>
1008.33	900.17
	60.50
	40.33

Because accounting assets rise by only \$1, the \$0.83 increase in Total Capital must be accompanied by an increase of \$0.17 in liabilities. Thus, the risk-weight for the “full-deduction” asset must be slightly less than 833% in order to arrive at a neutral effect on the Tier 1 ratio when compared with the capital deduction method.

Appendix 4

Institutions in the RMA Capital Working Group:

ABN AMRO	Bank of America
Barclays	Capital One
Citigroup	Comerica
Countrywide	HSBC/North American Holdings
JPMorganChase	KeyCorp
M&T	RBC Financial
State Street	SunTrust
Union Bank of California	U.S. Bancorp
Wachovia	Washington Mutual Bank
Wells Fargo	

Staff participating in preparation or review of this paper:

Bank of America: John S. Walter, Senior Vice President, Risk Capital & Portfolio Analysis

Capital One: Geoffrey Rubin, Vice President, Strategic Finance; Lin Li, Senior Manager, Strategic Finance; William Nayda, Senior Director, Strategic Finance

HSBC/North America Holdings: John Zeller, Executive Vice President, Credit Risk Management; John Roesgen, Senior Vice President, Risk Management; Stephen Mongulla, Group Director, Retail Credit Management; Jodi Richard, Group Director, Corporate Risk

JPMorganChase & Co: Adam Gilbert, Managing Director; Michel Araten, Senior Vice President; Joseph P. Lyons, Vice President

KeyCorp: Robert Kula, Senior Vice President; Thomas Boltja, Vice President

RBC Financial: Lyn McGowan, Senior Manager, Basel Accord Implementation; Chitra Muralikrishnan, Senior Manager, Financial Policy and Economic Capital; Michael Cussen, Basel Coordinator; Jason Smith, Senior Manager, Credit MIS

State Street: F. Andrew Beise, Basel II Risk Management Content Leader; Norman J. Greenfeld, Director of Counterparty Review; Joseph J. Barry, Vice President, Regulatory & Industry Affairs; Kim Milosh, Basel II PMO

SunTrust: Toni Stanek, First Vice President, Enterprise Risk Management

Union Bank of California: Paul C. Ross, Senior Vice President, Enterprise Risk Reports/Analysis and Basel II Project Management Division Manager; Desta G. Medhin-Huff, Vice President, Credit Portfolio Risk Analysis; Jouni Korhonen, SVP, Portfolio Risk Management

Wachovia: Gary Wilhite, Senior Vice President, Credit Risk Management; Avery Wise, Vice President, Credit Risk Management

Washington Mutual: John Stewart, Senior Vice President; Kurt Wisecup, First Vice President; Amy Alexander, First Vice President

Risk Management Association: Pamela Martin, Director, Regulatory Relations & Communications

Promontory Financial Group: John Mingo, Managing Director