May 31, 2001

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

Re: The New Basel Capital Accord

Ladies and Gentlemen:

Bank One Corporation appreciates the opportunity to comment on the Basel Committee's consultative document outlining "The New Basel Capital Accord." Bank One is a multi-bank holding company with managed assets in excess of $315 billion as of March 31, 2001, with business activities covering the full spectrum of retail and commercial financial services.

Bank One applauds the Committee's efforts to introduce greater risk differentiation into bank capital requirements. We are impressed by the progress that the Committee has made since the last draft of the Proposal in June 1999, and commend the Committee for their stated goal of establishing a minimum, risk-based capital standard for banking institutions. We emphasize that any measure of capital adequacy established under Pillar 1 of the Proposal should represent a true minimum and not one that will influence a bank's decision making under normal operating conditions.

We support the proposed approach that would allow progressively more sophisticated banks to incorporate internally developed parameters into its regulatory capital determination. However, we do note below several inconsistencies that may disincent banks from moving to the more advanced approaches. We strongly urge the Committee to consider, where appropriate, the use of internal capital allocation models as the primary driver in assessing capital adequacy. Ultimately, Bank One would prefer to see regulatory capital aligned with models that drive economic decision making, where capital levels are measured and driven by internal evaluation and risk management processes, overseen by supervisors, and validated by financial markets.

We would like to highlight the following issues as they relate to the general framework proposed:

- The standardized framework should not be used to perpetuate the current framework where banks are classified as well-capitalized if a certain minimum ratio is achieved. Rather we would encourage the Committee to view the standardized measure of capital adequacy as a true minimum. In other words, all banks would be required to operate above a minimum threshold, although achieving the minimum does not imply capital is adequate.

- While understanding the objective of maintaining the current level of capital in the financial system, we emphasize the need for a process where capital levels are fluid and adjust to business decisions as risk profiles change. Without such dynamics, there is little incentive to enhance risk management processes and undertake risk mitigation activities, which themselves must be viewed from a risk versus return perspective.

- We are disappointed that the Committee has constructed a definition of economic capital that covers both expected and unexpected losses, which is in contrast to the generally accepted notion that capital is only needed to cover unexpected losses. However, having done so it is imperative that the Committee not limit the amount of the general reserve that can be counted toward Tier 2 capital since the reserves can be considered either as a form of capital or as covering expected losses.

- The Proposal fails to acknowledge that banks operate at various levels of solvency protection, and that market established capital requirements adjust according to an institution's debt rating. The Proposal should consider establishing minimum capital requirements consistent with a global minimum level of solvency protection that should be far less than the level at which most large U.S. banks operate.

- In terms of the scope of the Proposal, it is imperative that capital requirements be applied equitably across the financial services industry. The Committee has indicated its intent to apply the Proposal on a fully consolidated basis to holding companies that are parents of banking groups. As many competitors in the financial services industry do not fall under the purview of this Accord, we encourage the Committee to work with appropriate supervisory authorities to ensure an equitable application of the Proposal across the financial services industry to avoid creating competitive disadvantages and new capital arbitrage opportunities.

- We are very concerned with the Committee’s proposal to attribute capital against operating risk. The Proposal will result in a material increase in the amount of regulatory capital required across the banking industry without a commensurate increase in risk. This is inconsistent with the Committee’s stated objective of maintaining the current capital levels and creates additional competitive disadvantages for the banking industry.

- We incorporate by reference comment letters to the Committee made by the commenting group comprised of financial institutions that are issuers of asset backed securities, by the group representing multi-seller conduits, and by the Risk Management Association (RMA). Bank One Corporation is a signatory on these letters and endorses the comments made therein.

With regard to more specific aspects of the proposal, we offer the following observations:

Standardized Approach:

- The gradation of risk weightings under the Standardized Approach lacks sufficient resolution. Industry convention typically identifies obligations rated at or below BBB- as non-investment grade and therefore ascribes significantly more capital to these transactions vis-à-vis investment grade transactions. The Standard Approach risk weights BBB+ through BB- corporate transactions at 100%. We recommend that the Committee consider inserting additional risk weights to improve the differentiation within the non-investment grade ratings.

- We continue to be mystified by the disparity in risk weightings applied to equally-rated corporate, asset backed, sovereign and bank exposure. Presumably the rating agencies are incorporating the exposure type and country into their estimates of default probability.

- The Standardized Approach ignores many forms of collateral that are typical to middle market and small business lending activities, e.g., receivables, inventory and personal guarantees. Much of the lending in these markets would not take place without the credit risk mitigation arising from these forms of collateral. This treatment may create an unintended disadvantage for collateralized lending that could lead to an increased cost of capital for middle market and small businesses.

- A similar situation exists for securitization exposures, e.g., liquidity facilities and programwide credit enhancement, provided by banks to asset backed commercial paper conduits. In this case, not only do liquidity providers benefit from the presence of collateral, but also from additional structural features such as the isolation of the assets from the bankruptcy estate of an originator. These factors will result in a lower LGD than unsecured or even secured credits, and consequently should require less capital. Ignoring these factors will put banks at a competitive disadvantage relative to unregulated institutions which participate in this market, and could cause corporate clients to lose access to this form of financing if costs were to become prohibitive.

- The Standard Approach proposes a fairly complicated process of "haircutting" collateral, requiring loan level calculations. It appears that the Committee is requiring a higher level of detail and sophistication to capture (and limit) loss mitigation benefits than it is ascribing to assessing the credit risk in the first place. While it is appropriate to be conservative in capital allocations, these proposed adjustments are not consistent with a minimum capital standard.

- As currently proposed, risk mitigation benefits of collateral will be allowed up to a capital floor. We do not support the floor at 15% of equivalent unsecured exposure and are concerned that the Proposal may distort the underlying transaction economics and risk/return dynamics.

Internal Ratings Based (IRB) Approaches:

- As noted, the Proposal contains a number of disincentives for banks to migrate to the advanced IRB approaches:

  - Progressively increasing EAD's under the more advanced frameworks lead to successive increases in required credit risk capital. This is evident between the Standardized and Foundation IRB Approaches, and is product specific between the Foundation and Advanced IRB Approaches (depending on internal estimates of EAD).

  - As proposed, the risk mitigation benefit from collateral, guarantees and credit derivatives is inconsistent between the three approaches. In order to guarantee the correct incentives, we recommend adopting an LGD framework for collateral under the Standardized Approach and then increasing the benefits (and types of collateral) recognized under the more sophisticated approaches.

  - The current proposal limits the aggregate benefit of the Advanced IRB Approach, establishing a floor at 90% of the Foundation IRB calculation. Presuming Pillars 2 and 3 operate in accordance with the Committee's expectations, we see no need to artificially constrain the capital benefit of strong risk management practices.

  - Under the Advanced IRB Approach, the Proposal incorporates a specific maturity adjustment that requires significantly more capital for longer-term exposures. On average, we do not believe that maturity distinctions between the three approaches should result in materially different capital allocations and would advocate the use of the same scaling factors across all three approaches.

  - While we understand the more advanced approaches will necessitate additional disclosure, the Committee should consider normalizing the disclosure requirements across all three approaches to create the appropriate incentives.

- LGD assumptions under the Foundation Approach lack the granularity required to properly assess risk. Transactions secured by collateral are subject to the same shortcomings as under the Standardized Approach, i.e., the Proposal contains insufficient categories to account for much of the collateral types used in middle market, small business lending and asset securitization positions.

- The Proposal's approach unreasonably limits the mitigation arising from taking real estate as collateral in conservatively-structured transactions. Real estate with LTV's below 65% should receive less than 40% LGD’s given that unsecured transactions receive 50% LGD’s. We would suggest that LGD’s in the range of 25% to 30% are warranted.

- The data requirements under the Advanced Approach are well beyond most institutions’ internal data capability today. Motivating financial institutions to track information and use this information for meaningful risk analysis is a laudable goal. Historically, financial institutions have been subject to mergers and acquisitions as well as new product introductions that have disrupted information systems or limited the requisite history to satisfy the Advanced Approach data requirements.

- The Proposal indicates that banks may supplement internal experience with external data. We caution the Committee that this creates an opportunity for banks with below average credit mitigation experience to use industry data rather than internal data when it results in lower capital allocations.

- By implementation, most banks will have retained 5 years or less of loss data, which implies that historical databases will be biased toward either better or worse times, rather than "through the cycle" default information.

Retail Exposures:

- The IRB Approach for retail exposures does not succeed in achieving an appropriate level of risk differentiation. The Proposal defines the capital multiplier without regard to maturity or product, and therefore all retail products are assigned the same capital for the same expected loss. Significant differences in risk are driven by other dimensions not explicitly captured by expected loss, e.g., form of credit and origination channel. As currently proposed, the measure fails to account for variance in loss volatility across the range of retail products.

- Effectively managed retail exposure increases credit risk diversification within a lending portfolio. However, the Proposal does not account for the cross-portfolio diversification associated with combining retail and commercial credits. Clearly a bank with equal retail and commercial exposure should attract less credit risk capital than a comparably-sized institution with predominantly wholesale lending. In the spirit of a minimum capital standard, the Committee should recognize the benefits appropriate to a truly diversified holding company.

- We accept the Committee’s definition of default at 90 days past due for formulating retail default distributions and exposure assumptions under the IRB Approach. However, we note that the definition of loss should continue to be consistent with industry, e.g., Federal Financial Institutions Examination Council (FFIEC), standards.

Operating Risk:

While recognizing that the Committee has just begun to formulate a policy surrounding operating risk capital attribution, we offer the following observations regarding the proposal for operating risk capital and related disclosure requirements under Pillar 3:

- Given the lack of industry standards in this arena, it is inappropriate to capture operating capital under the rubric of a minimum capital standard. Instead, we recommend the Committee default to Pillar 2 and look to supervisors to provide active oversight of operating risk management, similar to the proposed treatment for interest rate risk.

- The less advanced of the proposed approaches provide insufficient differentiation for the various forms of operating risks, and all approaches fail to account for the mitigating benefits of insurance and strong internal controls. We view the Standardized Approach as the most practical of the three approaches for operating risk, although the calibration of the beta-factors is critical to understanding the true ramifications of this Proposal.

- Targeting operating risk capital at 20% of an institution’s regulatory capital base is excessive. The Committee should be careful to avoid blurring the distinction between operating, credit and market risk. It is our expectation that true operating risk capital, as incorporated in a minimum capital standard, is much lower than 20%. While on average several larger institutions may hold approximately 20% of their capital base for operational (and business) risks, by definition a true minimum standard should be lower than the average.

Concluding Remarks

Bank One is pleased with the improved risk differentiation offered under the new Accord. We applaud the Committee's attempts to maintain the capital strength of the banking industry and we recognize the huge leap that the new proposal represents from the 1988 Accord. The development of a truly risk-based capital measure is a complex task sure to draw as many detractors as supporters. Recognizing that no standardized method of establishing capital requirements can capture all risks, we reiterate our support for a process where measurement of capital adequacy is driven by internal evaluation processes, overseen by regulators and validated by financial markets.

We appreciate the opportunity to comment on "The New Basel Capital Accord" and look forward to the Committee's final recommendation.

Respectfully,

/s/ Charles W. Scharf

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