Bank of America

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

Federal Reserve Board
Basel 2001 Capital Proposal, Mail Stop 179
21st and C Streets, NW
Washington, DC 20551

Basel 2001 Capital Proposal
Office of the Comptroller of the Currency
Mail Stop 3 – 6
250 E Street, SW
Washington, DC 20019

Re: Basel Committee on Banking Supervision
Second Consultative Paper "The New Basel Capital Accord"

Dear Messrs. and Mmes.:

Bank of America Corporation ("Bank of America") appreciates the opportunity to comment on the consultative document entitled "The New Basel Capital Accord" ("the Revised Proposal"). Bank of America, with $609 billion in total assets, is the sole shareholder of Bank of America, N.A., the largest bank in the United States ("U.S."), with full-service consumer and commercial operations in 21 states and the District of Columbia. Bank of America provides banking and investing services, corporate and investment banking, and financial products and services through state-of-the-art technology to individuals and businesses across the U.S. and around the world. As a growth company we serve customers through more than 4,400 domestic offices, 38 international offices, 13,800 ATMs, 90 regional client telephone service centers and the largest online bank in the U.S. with three million clients.

Bank of America welcomes a new look at the principles for determining capital adequacy. This is an extremely complex but vitally important proposal for the banking industry, regulatory authorities and the marketplace. While the existing Accord has served a purpose, it does not provide for regulatory capital requirements that reflect the risks associated with the portfolios or operations of individual banks or of the banking system as a whole.

Bank of America is a member of the Institute of International Finance ("IIF"), the Risk Management Association ("RMA") and the International Swaps and Derivatives Association ("ISDA"), and has participated in the preparation of the comment letters of those organizations as well as other groups. With some minor differences, we endorse the comments contained in the comment letters of those

organizations. Therefore, we have refrained from repeating many of the more technical comments that would be common to Bank of America, IIF, RMA and ISDA.

- Bank of America Response To Basel Second Consultative Paper -

We believe that the proposals contained in the Revised Proposal are a step in the right direction. However, we do not believe that the New Accord as proposed in the Revised Proposal is a significant improvement over the present Accord. The current proposals continue to be highly arbitrary. These proposals do not achieve the stated objectives of making minimum regulatory capital requirements truly risk-related and consistent with economic capital requirements. The advanced approaches described in the Revised Proposal will be costly to implement, but there is little incentive for banks to adopt them rather than the standardized approaches. We believe that further changes must be made in order to produce a revised Accord that meets the stated objectives and provides incentive for banks to use the advanced approaches. Given the alignment of incentives and necessary changes, sophisticated banks should be allowed to immediately adopt the advanced approaches without consideration of floors and without interim periods using simpler approaches.

The Revised Proposal reflects a work-in-process, rather than a near-final product. Much needs to be done to produce a New Accord that meets the objectives of this round of revisions. We understand that the Committee's staff had not completed work on portions of the proposals prior to release of the Revised Proposal, and that the staff has continued to develop those portions during this comment period. We believe that the current December deadline does not allow sufficient time for consideration of comments due currently, and for incorporation of changes due to those comments. The Committee's schedule provides no opportunity for industry comment on the final proposals on those portions that were not fully developed in the Revised Proposal, or on changes that are made as a result of this round of comments. We believe that a third consultative paper is needed, along with a reasonable period for analysis and comments. It is vitally important that the inadequacies of the Revised Proposal be resolved before a new Accord is adopted. It is far more important to produce an Accord that banks and regulators can live with for the next decade than it is to produce a new Accord by December. Therefore, the December deadline must be discarded.

We urge the Committee to take the time to refine the proposals so that they meet the stated objectives before adopting a revised Accord. Holding to a pre-conceived target date at the cost of failing to fully achieve the objectives of this round of revisions would be a disservice to the banking industry and those served by it.

Some of the major areas of concern that need to be addressed are discussed in the body of this letter, and include the following:

- The objectives of the proposal, especially the arbitrary nature of the proposed Accord.
- The lack of adequate incentives for banks to move up the continuum of approaches.
- The undeveloped nature of the retail portion.
- The incomplete condition of the operational risk proposal.

Objective of Minimum Capital Requirements

Both the current Accord and the Revised Proposal are highly arbitrary in their approach. Neither gives a clear statement of the Committee's objectives, justification of the arbitrarily imposed capital charges or adequate support for the required values in the computations.

We believe the committee should make a clearer statement regarding the objective it seeks through setting minimum capital standards. That statement should include a standard of soundness that is grounded in a quantifiable definition of insolvency. Such an approach should define soundness in terms of the probability of insolvency for the institution over a specified time horizon. Measurement of this probability of insolvency should be linked to unexpected losses of the bank's operations and portfolios. An explicit statement of objective in these terms does not appear in the document or in the previous accord. However, it is clear that such a concept played an implicit role in determining risk weightings for the proposed Internal Ratings Based ("IRB") approach for credit risk capital requirements and in the contemplated Internal Measurement approach for operational risk. The standard of soundness should be specified explicitly as a guiding principal. Further, it must be applied uniformly across risk categories and measurement approaches to ensure equitable treatment across institutions and promote optimal resource allocations within institutions.

The Revised Proposal states that the committee expects to retain the current level of capital for the banking system in aggregate. We believe that this is an inappropriate objective. The capital requirement for any bank and therefore for the banking system in total should reflect the level of risk that is present.

The Revised Proposal contains a charge for operational risk that is engineered to produce an aggregate capital assignment of 20% of the current minimum requirement. The operational risk capital requirements for banks implementing the more sophisticated Internal Measurement approach will be subject to an unspecified floor relative to this predetermined level for at least two years. The reduction in capital requirements for credit risk will be also be limited under the Advanced IRB approach to 90% of the amount calculated under the Foundation approach for the first two years. We believe that arbitrary starting points and floors on capital reductions are inconsistent with the objectives of a risk-based system.

The floors create a disincentive for institutions to migrate to the advanced approaches. In addition to incentive issues, the implementation structure of the floor increases the costs of compliance. Since the Advanced IRB floor is based on the results of the Foundation IRB approach, institutions will be required to calculate capital under two separate models.

Certain banks will enjoy a reduction in capital for credit portfolios when the more sophisticated risk measurement approaches are implemented and the transition period has elapsed. It is unlikely, however, that the total capital requirement will be reduced under the New Accord given the approach for operational risk. Since the methodologies and databases for measuring operational risk are still in a nascent stage of development, we believe most banks will use the Standardized approach for operational risk for the intermediate term. The benefit that is derived from improving the sophistication of the credit risk approach by replacing the current arbitrary risk weighting scheme is eliminated with the introduction of an equally if not more arbitrary scheme for operational risk.

In summary, the current proposal continues to be based on an arbitrary decision as to the amounts of capital that will be required for benchmark assets and for operational risk, without a foundation that establishes that these amounts are appropriate for the risk levels associated with these categories. Since most of the factors and parameters in the new Accord are developed around this arbitrary pre-determined level, the linkage of regulatory capital to the risks of insolvency is tenuous. To achieve the objective of a truly risk-related capital requirement, these arbitrary decisions should be eliminated and requirements should be aligned with the economic capital models of best practice institutions.

Definition of capital

The Revised Proposal continues to use the current, artificial definition of capital and an arbitrary limitation on the amount of reserves that may be included in capital. We believe that capital should be redefined in keeping with accepted accounting principles, and that general reserves and unallocated provisions for loss contingencies should be included without limitation in the determination of regulatory capital requirements.

An institution's primary capital is provided by equity, in the form of paid-in capital and retained earnings. General reserves, which are distinct from provisions for loss contingencies, are merely a means of setting aside part of retained earnings within the institution's capital. They remain a part of the institution's capital, but cease to be available for payment of dividends. There is no justification for excluding any part of general reserves from primary capital.

Provisions for loss contingencies, which are commonly referred to as reserves, are a direct reduction of capital and of the net carrying value of the assets associated with the loss contingencies. However, the act of provisioning has the effect of allocating capital to the associated risk in the amount of the provision. Accounting standards regarding provisioning vary between countries, such that provision amounts that would be considered inadequate in some countries are considered excessive in others. While we urge the Committee to work with the various accounting standard setting bodies to eliminate these differences, it is unrealistic to expect harmonization of provisioning and reserving standards within the next few years. Until that occurs, any limitation on the amount of provisions and general reserves that may be included in capital will be unfair to banks in some countries.

Therefore, the full amount of all provisions should be considered primary capital for purposes of assessing capital adequacy. There should be no arbitrary limitation on the amount of the provisions included in primary regulatory capital. Except where a write-down or specific allocation of provision to a particular asset has been made, the capital requirements to support assets should be determined based on the carrying value of the assets without deducting unallocated loss provisions.

Subordinated debt may function as secondary capital. However, there is no empirical evidence demonstrating that it is appropriate for half of the regulatory capital to be secondary capital. Since default on subordinated debt will trigger involuntary bankruptcy of a bank holding company in the US, reliance on subordinated debt to cover the institution's risks of losses is inconsistent with the institution remaining a going concern. Subordinated debt does provide protection for the deposit insurance fund and market discipline. As such, we agree that some amount of subordinated debt is beneficial. However, we

question the prominent role given to subordinated debt in Tier 2 capital and the absolute level that is required by current regulation.

Revision of the Credit Risk Requirement

We support the revision of the credit risk capital requirement to better reflect the risk elements of the portfolio. We believe that a truly risk based approach requires that each credit or homogeneous pool of credits is evaluated individually with respect to its contribution to portfolio losses. We do not believe that any approach making broad assumptions about borrowers is consistent with the concept of risk based capital requirements.

In both the Advanced and Foundation methods, the variables have been determined so as to produce a pre-conceived capital requirement for a benchmark asset without regard to whether or not that is the most appropriate result. As a result, the values of the variables are often very inappropriate for the specific components of a bank's portfolio. Banks should be allowed to use the values for variables that are appropriate for their assets. As a part of Pillar II, regulators should review those values and determine that the values used are comparable to those that would be used by others in determining the economic capital requirement for an institution with a similar portfolio.

We applaud the efforts of the committee to adopt an evolutionary approach where banks can apply increasingly sophisticated approaches subject to minimum qualifying standards. We are concerned about inconsistencies as banks move from one stage of the regulatory framework to the next. As a Bank evolves to more sophisticated approaches, we would expect the conservative bias of capital requirements to be reduced as a reflection of greater confidence in the methodology and data.

While this may be true in aggregate, certain classes of assets receive disparate treatments in the various risk measurement approaches. These inconsistencies should be harmonized before final implementation of the Accord. For example, lower risk weighting is applied for short term lending to banks in the standardized approach. Yet, when a Bank moves to the IRB Foundation approach the treatment of maturity disappears altogether. A distinction on the basis of maturity then reappears in the Advanced approach but is constrained to a minimum maturity of one year. The treatment of off-balance sheet commitments is also inconsistent across approaches. Under the standardized framework, the credit equivalent factors are 20% and 50% for assets with original maturities less than one year and greater than one year, respectively. However, in the Foundation IRB approach the credit equivalent amount of these assets is increased to 75%. This figure, along with others, is too high relative to our internal experience. In the Advanced IRB approach, the exposure factor for off-balance sheet commitments would likely be reduced back to its previous level.

While we agree with the concept of providing a Standardized, a Foundation and an Advanced method of determining capital requirements for credit risk, we do not believe the currently proposed methods provide sufficient incentive for banks to move from the Standardized to either the Foundation or the Advanced method. The costs of making such a move are not justifiable. The Foundation and Advanced methods should be redesigned to provide stronger incentives to upgrade methods in the form of lower capital requirements to those banks that have less risky portfolios. Without an incentive to move from the

Standardized method, the inclusion in the Accord of the Foundation and Advanced methods is futile. That said, the standardized credit approach is only a modest improvement over the existing Accord.

The IRB approach, particularly the Advanced version, is a promising development. The IRB approach is a first step in the evolution to a models based process. However, this approach stops short of a full models approach reflecting the methodologies that sophisticated banks employ in their internal efforts. We believe that, with assistance from the industry, such an approach could be made acceptable to regulators and would reflect the economic risks of each Bank's portfolio.

The proposed calibration process as outlined in the document targets an 8% capital ratio for a benchmark asset and sets the capital requirements for other assets on a relative basis to that benchmark. As a result, the arbitrary nature of the current Accord with respect to the absolute level of capital is retained and the linkage of required capital to the risk of insolvency remains tenuous.

In general, we find that the directional relationships between the underlying risk drivers in the model are correct. However, there are substantial differences in capital requirements between our internal economic capital model and the regulatory capital model. These differences are significant both in absolute and relative terms. They are disturbing since the new Accord rules were intended to approximate economic capital models. For example, the capital charge for our commercial portfolio using the advanced IRB approach is 1.8 times our internal calculation of economic capital at the 99.5% level of confidence. The capital charge using the Foundation IRB approach is over four times our internal economic capital figure at the 99.5% level.

The new Accord, particularly the IRB Foundation approach, continues to use extremely conservative assumptions for large segments of the portfolio. These assumptions yield minimum regulatory capital amounts that are higher for some products than internal capital assignments referencing even the more stringent AA standard of insolvency.

Standardized Approach for Corporates

Assigning credits to a small number of buckets does not reflect the distribution of loss in the portfolio. The vast majority of the portfolio, 80% of exposure, is to unrated borrowers and thus will continue to receive the 100% risk weighting in the current Accord. The capital requirements for rated corporates, sovereigns and banks still combine too many ratings into single buckets and do not appear appropriate in relation to the loss probabilities in the higher quality buckets. Although one bucket has been added to the corporate weightings since the original consultative document, we still believe that the bucketing approach is too broad.

The recognition of credit risk mitigation techniques is certainly an improvement over the current Accord but stops short of reaching the appropriate level of capital reduction. There is a conservative bias to the treatments for financial guarantees and collateralized transactions. For financial guarantees issued by sovereigns, central banks and commercial banks, the committee has adopted a substitution approach whereby the risk weighting of the guarantor is substituted for that of the borrower. This approach ignores the fact that a double default of both guarantor and borrower is a much lower probability event than

default of the guarantor alone. The risk of loss should be determined based on the joint probability of borrower and guarantor default with reasonable assumptions regarding correlation.

Guarantees from corporates are treated even more conservatively. For example, 15% of the guaranteed amount retains the borrower's original risk weighting. The supporting logic is based on the legal and enforceability risks of credit derivative contracts. We believe these are operational risks and therefore should not be included in the credit risk requirements. For transactions secured by limited types of financial collateral, a conservative approach is again applied. After haircuts on the value of the collateral for volatility, the risk weighting will not fall below a floor of 15% regardless of loan to value ratio. We suspect that logic for this treatment similarly overlaps with operational risk.

Finally, we are concerned about the internal consistency of the standardized approach. Banks and corporates are assigned different capital requirements even if they are rated consistently. Distinctions are made for maturity but only in the cases of off-balance sheet commitments and bank loans. Thus, a 3-month loan to a BBB+ corporate borrower would require 8% capital while the same loan to a BBB+ bank would require 1.6%.

Internal Ratings Based Approach for Corporates

The IRB approach allows banks, which meet minimum eligibility criteria, to determine regulatory capital using their internal assessments of default probability, loss given default and exposure at default. Two versions, Foundation and Advanced, have been outlined; each with increasingly sophisticated methodologies and more stringent qualification criteria. The Foundation approach is an entry point for banks wishing to use internal assumptions of default probability to derive capital requirements. Under the Advanced approach, banks are allowed also to use internal estimates of loss given default and exposure at default in estimating their capital requirements.

While the committee has ruled out direct use of internal models for the determination of minimum capital requirements, it is obvious that a portfolio model approach was used to set the benchmark risk weightings associated with each combination of default probability, loss given default and exposure. It would serve the industry for there to be more transparency as to the development and underlying assumptions of this model. This would enable advanced practitioners to reconcile the regulatory model with internal models. In the ensuing dialogue, the industry would provide the necessary feedback to improve the IRB approach.

Although we understand that the methodology relating default probabilities to capital requirements was originally based on the CreditMetrics portfolio model, the approach for determining benchmark risk weightings does not represent mainstream economic capital methodologies. We believe it would serve the industry to use a more standard methodology such as the commonly used default mode approach. If necessary, a migration risk component could be added to account for mark to market effects on assets with maturities extending beyond the capitalization horizon. This form of model would have well understood properties and would better align with mainstream economic capital methodologies.

As mentioned earlier, the IRB approaches were calibrated to yield an arbitrary 8% capital requirement for the benchmark asset. We believe the process for doing so introduced an upward bias in the absolute capital requirements and distortions in the relative capital requirements across assets. Based on our

understanding, the initial model estimated unexpected loss in a fashion consistent with bank's internal economic capital models but at a confidence level that is more appropriate for minimum standards than more stringent internal standards (i.e., 99.5% versus 99.97%).

Except for issues with individual parameters, we agree with the analytic methodology for setting the Benchmark Risk Weights using the chosen method. However, two subsequent adjustments were applied in order to calibrate the model to the arbitrary 8% capital ratio for the benchmark asset. First, expected loss and unexpected loss were summed to arrive at the regulatory total capital requirement. Second, the resulting amount was multiplied by a factor on the order of 1.5 to gross up the benchmark asset's capital ratio to 8%.

We strongly believe it is inappropriate to assign capital for expected loss. Expected loss is covered by pricing and absorbed by the revenue that is earned by business activities. Assigning regulatory capital for expected loss implicitly assumes that no revenue is generated by business activities during the capitalization horizon. Since expected loss increases with default probability, its inclusion distorts the relative capital requirements compared to results based on unexpected loss alone. In effect, the relationship between default probability and capital becomes steeper. The second adjustment, which scales up the previous result by a factor of 1.5X, compounds the effect and further distorts the relative relationship between default probability and capital. The negative effects caused by the calibration process are greatest for middle market, small business and retail lending operations. While we note this issue in the context of the corporate model, we feel that the calibration process is a fundamental flaw in the retail model as well.

In addition to the general calibration issues, there is an unduly conservative bias in the parameters chosen for the Foundation IRB approach. First, the mandated assumption for loss given default is 50% for exposures without recognized financial collateral. This assumption would likely apply to the vast majority of a portfolio. Internal experience and published studies suggest that 30% is a more appropriate level for unsecured lending. To better represent the risks of the middle market sector, we urge the committee to consider a specific treatment for non-financial collateral such as fixed assets, inventory and accounts receivable. Secondly, the exposure in event of default is specified as current outstandings plus 75% of off-balance sheet commitments. This factor also appears high relative to internal experience and the rules of the standardized approach. Thirdly, the maturity of all assets is assumed to be three years. That assumption is unwarranted. There is significant variation in the maturities of assets and maturity has an obvious impact on risk levels. Clearly, banks that are capable of satisfying the eligibility criteria for default probability estimation will also be capable of providing the maturity schedules for their assets. Finally, the same conservative approach to credit risk mitigants discussed earlier with respect to the standardized approach are carried over into the Foundation IRB approach.

The proposed granularity adjustment accounts for diversification and/or concentration in the portfolio. Although its calculation is one of the more complex elements of the New Accord, we believe it is an important component of risk sensitive capital requirements. Banks with very diversified portfolios should expect to get some relief through this adjustment. However, as we understand it, the granularity adjustment only takes into consideration the effects of name concentration. The adjustment should also consider diversification across industry and geography. Furthermore, the scope of the granularity adjustment should be broadened to include the stabilizing presence of the retail portfolios.

The conservative biases noted above will result in substantially higher capital requirements as a bank migrates from the Standardized approach to the Foundation IRB approach. Ultimately, we believe that banks that move on to the Advanced IRB approach would attain significant capital reductions in credit risk capital if they are permitted to use parameters that reflect historical experience and are not unduly conservative. We agree conservative choices for parameters are necessary in some elements of the IRB framework to reflect uncertainty in the model approach and its parameter values. However, it would be an unfortunate consequence if banks found it uneconomic to implement the Foundation IRB approach.

Ratings Based Approach for Retail

Absence of a Foundation IRB approach is a significant shortcoming of the Revised Proposal for retail portfolios. To be consistent with the treatment of corporate portfolios, we believe that a Retail Foundation IRB approach should be developed. Under both the current Accord and the Standardized approach of the New Accord, there is no change in the minimum capital requirements for retail assets. These approaches provide virtually no risk differentiation and are inconsistent with the objectives of risk based capital requirements. As such, many banks will enjoy no improvements in the treatment of retail assets unless the Advanced IRB approach is implemented. We believe that a Foundation IRB approach could easily be developed similar in design to the corporate approach or an alternative design based on the common single equation economic capital framework. We would be happy to assist the regulatory authorities in that regard.

The overall calibration of the retail portfolio capital requirements has major problems. It is our understanding that the Advanced IRB approach for retail assets was developed by adjusting the results of the corporate model using a simple rule of thumb. Specifically, retail economic capital should be approximately 50% of corporate economic capital for the same default probability and loss given default. Since the basis of the risk weights in the Advanced IRB approach is the corporate model, our commentary on the corporate approach should also apply to the retail portfolios. Further, we believe the implicit parameters for the corporate approach are not applicable to retail portfolios. Correlations between retail borrowers are much lower than those of corporate borrowers. This results in loss distributions with less potential for extreme loss events and therefore should lead to significantly lower capital assignments for retail assets.

We have applied the Advanced IRB framework to our retail assets on a test basis. The initial findings suggest that the minimum requirements under the New Accord are significantly greater than internal measures of economic capital even at the standard of insolvency based on a AA target credit rating. We believe that improperly specified correlations and the inclusion of expected loss in the calibration primarily drive this result. Additionally, the model assumes that all assets have maturities of 3 years in retail portfolios. This is a particularly conservative assumption with regard to credit card portfolios. We do not understand why maturity should only affect the capital requirements of corporate assets.

On an operational note, we disagree with the reference definition of default for the retail portfolios. The standards applied to the corporate portfolio are not appropriate for the retail portfolios. A significant proportion of retail loans that become 90-days delinquent typically return to performing status and are never charged off. As such, we believe the definition of default for retail assets should be later in the

delinquency cycle. Specifically, we believe the definition should be aligned with charge-off policies. Internal capital models for retail assets typically define default as coincident with charge-off.

With regard to the required level of segmentation, we agree that appropriate segmentation of retail assets is critical to the risk measurement process. However, the strategy defined in the Revised Proposal is too inflexible. In particular, it requires segmentation along product type and application credit score. It also requires segmentation along delinquency status and vintage unless supervisors agree that these dimensions are not appropriate. We disagree with the notion of a preconceived segmentation approach. We are concerned about the costs of maintaining models for a segmentation approach that has no other use than to satisfy regulatory requirements. We believe that it should be left up to the bank to determine the appropriate level of segmentation and the approach should be reviewed under Pillar II.

Operational Risk Capital Requirements

We do not believe that operational risks are measurable using methods and data that are available at this time. While progress in developing quantitative methods has accelerated in the last few years, we believe the industry is still a number of years away from arriving at an internal measurement approach that would be suitable for minimum regulatory requirements. Only a handful of banks have implemented quantitative approaches for measuring operational risk and the models are largely untested. Bank of America, like many others, is in the early stages of gathering the data to explore these approaches. We urge the Committee to delay implementation of a minimum regulatory capital requirement until proven methods based on empirical evidence are available. That said, we offer the following observations.

A capital requirement for operational risk must begin with a clear and reasonable definition of operational risk. The Committee's definition should be made more specific. It should include only unexpected losses within a defined time period that are a direct result of an operational risk. Expected losses should not impact capital requirements as current period revenues and loss provisions cover these losses. References to indirect losses should be excluded from the definition of operational risk. The estimation process for indirect losses is highly subjective and unlikely to be consistent across institutions. Finally, there should be no overlap between the definition of operational risk and any of the other risks for which a capital allocation is required. Specifically, the current proposal's inclusion of legal risk both as the "w" factor in credit risk and in operational risk should be resolved.

A capital charge for operational risk should be not imposed simply to keep the overall level of a bank's regulatory capital requirement the same as under the existing accord or at any other arbitrary predetermined level. Both the Basic Indicator and Standardized approaches for operational risk begin with a predetermined notion of the operational risk capital amount. Each is calibrated to yield a capital requirement equal to 20% of the current minimum regulatory standard (i.e., 8% of Risk Weighted Assets). The arbitrary nature of these approaches is twofold. First, they assume that operational risk comprises 20% of the economic risks of any bank. Second, the current amount of regulatory capital based on the 8% standard is arbitrary in and of itself since it is not linked to a quantifiable definition of insolvency.

We believe that the current calibration is upward biased. We understand that it was based on a survey of the percentage of capital for risks other than credit and market risk among a small sample of institutions. We point out that institutions may have included a broader array of risks in their response than simply

operational risks. In our case, business risk is defined to include both operational risk and economic risk (i.e., competitive behavior and product obsolescence, reputation). This latter category does not fall within the scope of operational risk as defined by the Committee. The economic capital requirement for pure operational risk therefore would be a lesser percentage of economic capital.

Furthermore, we disagree with the notion of setting operational risk capital for all banks based on a single set of risk factors applied against exposure indicators such as gross income or average assets. Such an approach assumes the operational risks of activities are constant across banks. We strongly urge the Committee to consider adding qualitative adjustment for the effectiveness of internal controls to each approach. At a more subtle level, the proposed approaches also assume that risk is directly proportional (linear) with respect to the exposure indicators. Studies have demonstrated the relation between gross income and operating risk is in fact non-linear. We believe that both the Basic Indicator and Standardized approaches therefore overstate the operational risk for large banks and understate the operational risks for smaller banks.

Our findings with regard to the appropriate capital allocation for business risk for our own institution do not necessarily indicate the capital allocation that would be appropriate for any other institution or for the banking system in the aggregate. The amount of capital appropriate to allocate to operational risk should vary among institutions, due to differences in the risks faced by the various institutions and their effectiveness in managing those risks. The current proposal does not adequately take into consideration differences in risks among institutions, or the degree to which their management of those risks is effective. It fails to take into consideration the effect of insurance coverage purchased by the banks in reducing operational losses. Surely a bank that obtains insurance coverage has a reduced need for capital to cover operational losses. As a result, the Revised Proposal fails to provide an incentive to reduce operational risks or to manage them effectively.

Finally, we object to mandated participation in industry operational loss data pools as a possible criterion for the advanced approaches. We have significant concerns regarding confidentiality and legal issues with these pooling efforts. Further, mandated participation will require banks to reveal proprietary information to competitors, to the detriment of the banks that contribute the information to the pool.

Compliance Burden

Compliance with the revised Accord will impose a costly burden on banks. This burden will be especially great on large, decentralized institutions with broad product assortments. The burden will be significantly less for smaller institutions, especially those with more limited product assortments and with more centralized operations.

In order to justify the cost of compliance, the revised Accord should offer the opportunity for an institution to achieve significantly reduced regulatory capital requirements under the revised Accord through effective risk management and risk reduction strategies. Unfortunately, we do not believe the current proposal allows most institutions to realize benefits that justify the increased cost of compliance. We believe that, with further revisions as suggested in this letter and in the comments of RMA and ISDA, a cost-effective Accord could be produced.

Disclosure Requirements

We understand the need for adequate disclosures concerning the risks faced by banks. However, we are concerned by the specific disclosure requirements in the current proposal. A requirement by the Committee to place specific disclosures within the body of an institution's financial statements infringes upon the function and prerogatives of the various national accounting standard setting bodies, as well as the jurisdiction of the Securities and Exchange Commission in the US. It also would make both the information disclosed and the models and assumptions on which information is based subject to an independent audit requirement in the US, and possibly in other countries. The audit requirement substantially increases the cost of complying with the disclosure requirement.

We believe that the Committee should review the disclosure requirements of the various national accounting standard setting bodies and the various bank regulatory authorities, and should limit the disclosure requirements within the body of the financial statements to those currently required by those authorities. Any additional disclosures the Committee decides are necessary should be made as supplemental information, outside the body of the financial statements. No disclosure of immaterial items should be required.

While the value of some of the disclosures to bank regulators is obvious, we question whether investors will understand and properly interpret much of this information.

Risk Diversification

The Revised Proposal fails to address and provide credit for risk diversification. It should be obvious that larger and more diversified institutions are less prone to insolvency, even if the specific risks associated with their portfolio and operations appear otherwise to be identical. Failure to address risk diversification penalizes larger institutions. Diversification should be recognized between sub-portfolios, industries and geographies. At minimum, diversification should be appropriately accounted for within the credit, market and operational risk categories. Even across categories, for example between credit and operational risk, there are significant diversification benefits. We urge the committee to consider these effects.

Summary

We are encouraged by the progress the Committee has made toward a risk-based capital requirement. We believe the Committee must work to eliminate the arbitrary nature of the Revised Proposal, to increase incentives to use advanced approaches, and to further develop the retail credit risk and operational risk provisions before a new Accord is adopted. While we realize that the Committee has a target date for issuance of a revised Accord that is now very close, we do not believe that target date is realistic in light of the shortcomings of the current proposal. We urge the Committee to push the target date further into the future in order to produce a revised Accord that will be truly risk-based and in line with economic capital requirements.

We would be happy to discuss our views in greater detail, or to discuss any new ideas that the regulatory authorities wish to pursue. In that regard, please contact John S. Walter, our Senior Vice President for Risk & Capital Analysis at (415) 953-0243, or Randy Shearer, our Director of Accounting Policy, at (704) 388-8433.

Sincerely,

James H. Hance, Jr.

James H. Hance, Jr.