THE NEW BASEL
CAPITAL ACCORD

COMMENTS ON THE CONSULTATIVE DOCUMENTS ISSUED BY THE BASEL COMMITTEE ON BANKING SUPERVISION IN JANUARY 2001

First Union Corporation
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EXECUTIVE SUMMARY

In January 2001, the Basel Committee on Banking Supervision (the "Committee") issued a revised collection of consultative papers outlining significant modifications to the current regulatory capital process. The proposal represents significant progress in the effort to achieve a more risk sensitive regulatory capital framework. By providing a range of options for the measurement of credit and operational risk which bring increased focus on banks' own internal risk measures, the Committee's proposal has the potential to more closely align economic and regulatory capital and to encourage banks to advance the state of their art in risk management.

The current proposal represents significant strides beyond the Committee's 1999 proposal and indicates the Committee's willingness to work closely with banks in order to develop a viable framework. We are in full agreement with the Committee on many points, but would like to offer additional suggestions for further refinement of the proposal. We encourage the Committee to move with careful deliberation and to continue its practice thus far of deliberately consulting with the industry about proposed changes. As the Committee and the industry both agree, the current proposal still contains a number of unresolved issues. We look forward to another opportunity to comment on further revisions.

The following section contains First Union's primary recommendations for modifications to the proposal. The remainder of this paper responds in greater detail to specific technical issues.

PRIMARY RESPONSE

Another Round of Consultation is required. It is the Committee's intention to conclude the consultative period and issue a final paper by year-end. We are sympathetic to the concern that the consultative period not continue indefinitely. However, First Union believes that it would be far worse to create an incomplete regulatory framework in the haste to implement a new Accord. In conversations with our supervisors, we hear phrases such as "That's a placeholder." or "This may change substantially." These areas–*e.g.* Retail, Securitization, Disclosure, Equity, and Operational Risk–are substantial elements of the proposal. We believe that the resulting Accord will be stronger if the industry has the opportunity to consult on a proposal that the supervisors view as complete.

The goal of the three approaches for calculating credit risk should be a progression toward increased *accuracy*. There are a number of places throughout the proposal where the Committee has chosen to take a conservative approach. By focusing on accuracy

rather than conservatism, the Committee can avoid the inconsistencies that exist in the current proposal. We recognize the desire for conservatism that is motivated by the Committee's mandate to protect the safety and soundness of the banking system. However, mandating out-sized capital values won't achieve those ends.

Create a continuum between the foundation and advanced IRB approaches. The current proposal views the two IRB approaches as separate and distinct, with banks classified as using either one or the other. The proposal does suggest that banks be allowed to move from the foundation approach to the advanced approach on a portfolio-by-portfolio basis. We urge that banks also be allowed to transition to advanced treatment on an input-by-input basis. For example, a bank that can qualify for the advanced IRB approach to use its own EAD estimates should be permitted to use them regardless of whether it has yet qualified for the advanced approach for other parameters. Further, under this framework, a bank that cannot qualify for the advanced IRB approach for a parameter may be able to compute its average value over the portfolio. Such a bank should be permitted to use this value. Approval for adoption of individual parameters could be contingent on developing a plan to achieve advanced status for all inputs. This process would encourage banks to adopt improved risk management practices wherever possible. It would also speed the transition from supervisory provided values to inputs that are more reflective of the underlying risk.

Balance complexity with benefit. While the goal for each approach should be to promote increasing accuracy, it is important to recognize that being highly precise on one parameter may provide little incremental value to the accuracy of the result if other parameters are imprecise. For example, under the standardized approach there is considerable complexity involved in computing the degree of credit risk mitigation achieved through certain limited forms of collateral. At the same time however, all unrated assets receive the same risk weighting regardless of their credit quality even though their underlying risk may differ substantially. There appears to be little incremental accuracy in computing these complex credit risk mitigation estimates.

More closely align the concepts of regulatory and economic capital. The Basel Committee has made significant strides in bringing together the concepts of regulatory and economic capital. However there still remain fundamental differences. The proposal indicates that risk weights under the IRB approaches were calibrated to cover both expected loss and unexpected loss. This is contrary to bank practices that view capital as a buffer against unexpected loss. Expected loss is covered by loan spreads as a flow concept or the ALLL as a balance sheet concept.

It is currently anticipated that the Tier 1 and total capital calculations will remain unchanged from the current Accord. Regulatory Tier 1 capital is defined as consisting of equity while Tier 2 capital is composed primarily of the allowance for loan losses and subordinated debt. Subordinated debt is not considered part of economic capital as it does not provide protection against insolvency. It does, however, provide protection against losses on insured deposits. If the Committee wishes to maintain a minimum total capital ratio to mitigate this risk, we recommend that it be calibrated against a specified percentile of the loss distribution rather than a specified multiple of the Tier 1 ratio. The

concepts and calculations for Tier 1 and total capital should be re-examined and redefined to allow them to be more easily integrated into an economic capital framework.

Operational Risk should be accounted for through Pillar II. While we share the Committee's view that properly capitalizing a firm's operational risk is desirable, we are not confident any of the options discussed in the proposal will accomplish this. We frame this view not as a criticism of the proposal, but as recognition of the difficulty in quantifying this risk type.

Accurate capitalization of operational risk is difficult due to both the episodic nature of the risk and the differences that exist among the control environments of business units and organizations. Our internal capital allocations have demonstrated to us how difficult instituting a common capital framework with limited empirical support can be. Over the past five years, we have evolved our internal approach to operational risk from a single factor model (like the Basic Indicator approach) to a loss distribution approach. While the complexity of the algorithms have increased, in reality we are not highly confident that business lines attracting higher levels of operational capital are proportionally more likely to suffer losses than those units with lower levels of operational capital. The "cause and effect" link for this risk type is simply not as strong as with other risk types.

We believe regulators would be best served to adopt one of two views regarding this risk. One option would be to account for this risk type solely in Pillar 2 - through qualitative assessments of each organization's measurement and management of operational risk. Under this option, there would be no explicit capital calculation made for this risk type. If this option cannot ultimately be selected, we recommend making the capital approach as simple as possible. Rather than forcing organizations to dedicate resources toward more complex capital approaches, we believe encouraging better management of operational risk would be more productive. In fact, having overly complex approaches may lead to a perception of science that does not exist and lead management to mistakenly focus less attention on areas that receive less capital.

If the Committee does elect to retain the proposed operational risk charge, further clarification is necessary regarding the types of risks such a charge is designed to cover. First Union distinguishes between event risk (which appears to be closely aligned with the definition of operational risk contained in the proposal) and business risk (which captures the risk of poor business models and rapidly changing business environments). If the Committee's intent is to cover only event risk, then calibrating the operational risk charge to 20% of regulatory capital is much too high. Our internal models indicate that a 5%-7% calibration would be much more appropriate.

Recognize maturities under 1 year. The lack of recognition in the advanced approach of maturities under 1 year stands out as a significant issue. Even within the standardized approach, the Committee has recognized the reduced risk of assets with terms of less than one year by providing a lower conversion factor for commitments under 1 year and a lower risk weighting for bank exposures under 3 months. Banks offer various products

that are specifically designed to be short term in nature. Failure to recognize the decreased risk of short term loans arbitrarily increases the cost of originating a safer product.

Recognize that guarantees can affect Loss Given Default and that collateral can affect Probability of Default. The structure of the proposed accord focuses on the 'notching' effect of guarantees on Probability of Default (PD), and the impacts of collateral on Loss Given Default (LGD). In constructing its current grading system, First Union recognized from historical experience that even when guarantors do not prevent default they can significantly reduce the loss. Likewise, obligors are less likely to trigger the technical definition of default on loans that are well secured by highly liquid prime collateral.

It is very important that the wording of the proposed accord not preclude banks from using guarantees in assigning LGD or collateral in determining PD provided that it can be demonstrated that such inputs are relevant. The advanced approach should encourage banks to use all of the information at their disposal rather than restricting their methods.

Reduce the level and frequency of required disclosures. First Union concurs that increased market discipline provides a very effective means of ensuring strong risk management. Unfortunately, as currently constructed, the disclosures will almost surely yield more heat than light. The requirements present significant problems on several fronts. First, detailed reporting may permit outsiders to identify and track large individual assets as they migrate through various risk ratings, thereby inadvertently releasing proprietary information. Second, observed PDs and LGDs are very noisy in commercial portfolios, especially when calculated over short time horizons or portfolio sub-segments. Statistics so calculated provide virtually no insight into the risk of the remaining portfolio. Third, providing highly detailed information could place banks at a disadvantage to other less regulated financial entities. There will be a very large asymmetry in information flow. Just as asymmetric treatment of capital treatment leads to arbitrage opportunities, so can asymmetric disclosure information. Fourth, such detailed disclosure may incent banks to employ practices that are less sound than they would otherwise use. For instance, the consultative paper states that PD should be "a conservative view of long-run averages, although banks would be free to use more conservative estimates." However, if banks must disclose their grade distributions and associated PD's, will they use more conservative estimates? Perhaps, but they will suffer when compared to peers which do not. Finally, because banks differ in their grading systems and risk management practices, detailed cross-sections will never be completely comparable between banks and may encourage investors to draw unwarranted conclusions.

In order to promote increased market discipline and provide investors with the best understanding of the bank's risk position, modifications must made. Quantitative disclosure should focus on capital usage for the portfolio and stratifications of it. Relying on Pillar II for the adequacy of the input quantities, the ultimate value of interest is capital. Qualitative descriptions of risk rating systems and risk management practices will help insure market discipline around processes without being overly burdensome or misleading as excessive cross sections of the portfolio can be.

CONCLUSION

The Basel Committee's proposal represents an important and conceptually sound step in developing a more direct relationship between regulatory capital and economic risk. We believe that the Committee is significantly closer to achieving its objective of creating a more comprehensive approach to addressing risks. There remain, however, some areas in the proposal that appear contrary to industry best practices and which fail to properly characterize the true underlying risks. We encourage the Committee to focus on accuracy rather than conservatism and to make modifications that will further align economic and regulatory capital.

TECHNICAL ISSUES

In addition to the primary issues described above, there are a number of more detailed points in the proposal that First Union would like to address.

PILLAR I

STANDARDIZED APPROACH

While marginally improved over the current accord, the standardized approach bears little relationship to economic capital. The majority of banks' assets are not publicly rated and so would not be impacted by the standardized approach's use of external ratings. Furthermore, those institutions that are most likely to remain on the standardized approach are in general least likely to be affected.

We suggest several changes to make the approach more risk sensitive and provide a smoother progression to the more advanced approaches. First, increase the number of Risk Categories in order to capture significant differences in credit quality such as exist between BBB+ corporates and B- corporates. In addition, remove the distinction between Sovereigns, Banks and Corporates. Such distinctions add complexity and at the same time distort the relationship between economic and regulatory capital for such entities. Finally, adjust the associated risk weights to more accurately represent the underlying risk. There is a much greater difference in risk between a loan to a AAA rated corporate borrower and one to a BB rated borrower than their risk weights of 20% and 100% would suggest. In addition to better reflecting risk, such adjustments would provide more continuity between the standardized and foundation approaches.

While the standardized approach does recognize various types of collateral and guarantees as providing credit risk mitigation, the complexity of the formulas involved is inconsistent with the high degree of imprecision embedded in the risk weights themselves. A simpler haircut approach applied to a broader class of collateral would be preferable. Regarding guarantees, it is not clear whether the criterion of being 'A' rated or better applies to all corporate guarantees or just to parental guarantees.

More importantly, the Committee should recognize that however it is structured the standardized approach provides little incentive to develop good risk management practices. It is in the best interests of both supervisors and banks to insure that the hurdle to move to the foundation IRB approach be set as low as possible in order to encourage the maximum number of institutions to focus on a more risk sensitive framework.

FOUNDATION INTERNAL RATINGS BASED APPROACH

The foundation IRB approach represents significant progress in regulatory capital not only because it makes use of banks' internal risk ratings to more closely align regulatory capital with economic risk, but because it also recognizes that capital is a continuous function of default probability and that solutions which are composed of 'buckets' of risk weightings are inherently flawed. However, while the foundation approach is a valid approach conceptually, its current implementation appears to result in a capital amount that is significantly higher than current, standardized, advanced and economic capital values.

The most significant issue with the foundation approach as it is currently structured is its focus on conservatism rather than accuracy. LGD and EAD supervisor-specified values and the use of credit risk mitigation techniques were all conservatively chosen. The result, however, is a capital amount that is overly conservative.

Rather than specifying a single universal value for LGD and EAD, the Committee should encourage the use of supervisor-specified values that are more representative of bank experience. Banks that cannot qualify for the advanced IRB approach for the treatment of LGD and EAD that nevertheless can, through internal and external data, compute average LGD and EAD values for their portfolios should be permitted to use such values. For those banks that are unable to make such calculations, supervisors should specify parameters that reflect the historical experience of their particular region rather than using universal values supplied by the Committee. Ideally, the process should form a continuum, as banks move from a supervisory provided placeholder, to a single average bank specific estimate, and then to more granular estimates.

The treatment of credit risk mitigation is another aspect of the foundation approach that tends to err on the side of conservatism. The types of collateral and guarantees recognized under the foundation approach are quite limited compared with those typically accepted by banks. In addition the process for determining haircuts based on collateral type, mark-to-market frequency, remargining frequency, and issuer type, appears overly complex in the context of a system that is going to use single LGD and EAD values as a starting point. A more straightforward haircut procedure applied to a broader range of collateral types would more a) accurately reflect the true risk in bank portfolios; b) be more reflective of the general precision of the approach; and c) be easier to implement.

There are several modifications that should be made in the treatment of guarantors. First, the Committee should reconsider the double default issue**.** The proposal reiterates the Committee's reluctance to incorporate the fact that the risk of a guaranteed loan defaulting is lower than that of either the borrower or the guarantor since both must default before a loss occurs. The Committee has noted that incorporation of such a double default effect would require the estimation of the correlation between the obligor and guarantor and that such calculations are too difficult to implement and validate. While this is true on an obligor-by-obligor basis, the Committee in calibrating the Benchmark Risk Weight formula has assumed a correlation of 20%. It would seem appropriate to use this same correlation in a double default calculation.

Second, the proposal should provide guidance for the treatment of multiple guarantors. In an effort to provide as much protection for the asset as possible, banks may obtain multiple guarantors for a single loan. At a minimum, the proposed accord should indicate which of the guarantors' PD's should be used in calculating credit risk mitigation. Furthermore, the presence of multiple guarantors should be considered as a justification for reducing the 'w' parameter from 0.15 to zero.

The proposal should also provide guidance on the use of non-corporate guarantees. Such guarantees should be acceptable, provided that the bank has an appropriate methodology for assigning a credit rating to non-corporate guarantors

Finally, greater clarification is needed regarding which guarantors will be recognized as providing credit risk mitigation. It is unclear whether the criterion of having a PD corresponding to an 'A' rating or better is to be applied to all corporates or only to parental guarantees. We recommend that the only requirement be a PD that is lower than that of the obligor and that no distinction should be made between corporate guarantees and those of banks, sovereigns and PSE's.

For both collateral and guarantees, further consideration should be given to the 'w' parameter that is used to assign a floor for credit risk mitigation. The desirability of such a parameter depends in part on how the Committee intends to differentiate between credit risk and operating risk. Arguably, 'w' is actually adjusting for operating risk (*i.e.* the failure of the collateral or guarantees to be implemented properly) since any credit risk concerns would have been considered in the haircut calculations for collateral and the assignment of risk weights for the guarantors.

If the Committee chooses to retain 'w', several modifications would be appropriate. First, it is unclear why 'w' is set to zero for guarantees from sovereigns and banks but not for corporates. As a general rule, there should be no distinction between equally rated sovereigns, banks, and corporates. Furthermore, while 'w' is currently set to zero for guarantees from sovereigns and banks, it remains at 0.15 for credit derivatives from those same institutions. There is no reason to make such a distinction between guarantees and credit derivatives. Instead, if 'w' is indeed accounting for credit risk rather than operating risk, the decision to set 'w' to zero rather than 0.15 should be based on the degree of collateralization or the rating of the guarantor.

Finally, one of the requirements for the implementation of the foundation IRB approach is the requirement that all loan ratings be reviewed annually. For some types of small commercial loans, however, the reduction in losses achieved through yearly servicing does not justify the costs involved. Pillar II should provide for the relaxation of this servicing requirement as well as other requirements whose cost outweighs their benefit.

ADVANCED INTERNAL RATINGS BASED APPROACH

Through the advanced IRB approach, the Committee has provided a method that calculates regulatory capital in a manner that is more consistent with economic capital and

with the bank's internal practices. It is important, however, that rather than being viewed as a separate approach from the foundation IRB, the two be considered part of a continuum. First Union encourages the Committee to permit the adoption of advanced IRB approach techniques on an input-by-input as well as portfolio-by-portfolio basis. For example, a bank that can qualify under the advanced IRB approach to use its own EAD estimates should be permitted to use such estimates regardless of whether it has yet qualified for the advanced IRB approach treatment for LGD's or other parameters. The goal across all three credit risk capital approaches should be to encourage more accurate risk management techniques wherever possible. Concerns regarding possible cherry picking of parameters or portfolios should be managed through Pillar II.

First Union in its grading systems takes into consideration that guarantees can impact LGD (guarantors may cover part or all of the loss once a loan has defaulted) and that collateral can impact PD (loans which are well collateralized with highly liquid collateral are less likely to technically default). It is important that the advanced IRB approach be interpreted in a manner that is flexible enough to recognize such variations.

The Committee has proposed two possible approaches for a maturity adjustment within the advanced IRB approach, the mark-to-market adjustment and the default-mode adjustment. First Union encourages the Committee to designate the Mark-to-Market version as the appropriate adjustment. The bank considers Mark-to-Market models as conceptually superior to Default-mode models. The increased sensitivity that Mark-to-Market models display with respect to maturity properly reflects the differences in risk

The proposal includes a floor for the first two years that would allow regulatory capital under the advanced approach to be no lower than 90% of the regulatory capital under the foundation approach. The Committee should reconsider the assignment of such a floor. Those banks approved for the advanced approach would have already had their grades validated and their processes approved by their supervisors. Given that validation, it is difficult to understand why supervisors might disagree significantly with the resulting capital amount and therefore require a floor as protection. As part of the process for qualifying banks for the advanced approach, supervisors will be able to determine the impact of the advanced approach on capital adequacy for that bank and would be able to postpone approval if the resulting ratios appear inappropriate.

If, however, a floor is deemed necessary, one based on current capital would prove as adequate as one based on the foundation approach and would not be as burdensome as requiring banks to calculate both the foundation and advanced approaches simultaneously.

RETAIL

Our supervisors have acknowledged that the treatment of retail portfolios currently outlined in the proposal is more of a placeholder, and that a revised version will be forthcoming. There are a few issues we believe should be incorporated in that revised proposal.

Portfolios of small business loans, credit cards and home equity loans all behave differently. It is unlikely that a single risk weight formula can account for those differences. As the Committee considers improvements to the retail calculations it should give consideration to the use of multiple formulas based on broad category types. In addition, the possibility of providing different definitions of default for different products should also be considered.

The Committee has debated whether to treat small business loans under the corporate framework or the retail framework. The choice of framework should be based on the manner in which the assets are managed. If such assets are individually rated in the same manner as corporate loans then it is appropriate to treat them within that framework. Likewise, if such loans are managed as pools, their required capital should be calculated within the retail framework. Because the current proposal contains only a single retail risk weight formula whose results are significantly different from the corporate version, the choice of framework for small business loans can have a significant impact on required capital. By providing a retail formula that is specific to small business, it will be possible to align the retail treatment of small business with its treatment under the corporate framework..

EQUITY EXPOSURES

We agree on the need for a risk sensitive process for assigning regulatory capital to equity exposures. We recommend that the Committee develop specific recommendations for the treatment of equity investments. Investment banking activities are a significant component of many large banks. The capital treatment on these assets is an area of great interest and importance.

PROJECT FINANCE

We question the value of a special treatment for project finance loans. While a conceptually valid argument exists for requiring greater capital for project finance because of the increased correlation between PD and LGD, the benefits achieved do not appear to justify the complexity involved. First, it is difficult to develop a clear definition of project finance that can be consistently applied across the portfolio. Second, for those subportfolios that do qualify as project finance, there may be other structural issues that ameliorate the impact of the higher correlation between PD and LGD. Finally, even absent any additional structural issues, it is not clear that the actual performance of project finance loans would be sufficiently different from other corporate loans to warrant a separate treatment

OPERATIONAL RISK

Unlike other risk categories, there appears to be no strong link between Operational Risk measures and subsequent losses. The imposition of a complex Operational Risk regulatory capital charge would not necessarily promote better risk controls and may in fact incorrectly focus the attention of the bank's management away from areas requiring improvement. We would prefer that Operational Risk be incorporated as part of Pillar II in the form of a qualitative analysis of the bank's Operational Risk management procedures. If, however, it remains as a component of Pillar I, we would recommend the

approach be kept simple given that there is little evidence to suggest that the more complex approaches provide more accurate loss predictions.

There are four key issues in the calibration of operational risk. First, the proposal's description and calibration of operational risk appear to be inconsistent. While the description of operational risk is fairly narrow, the calibration seems to cover a much wider scope of risk(s). It may be that sufficient clarity did not exist when banks reported to the Committee the levels of operating risk from their internal allocation models (used in the Committee's calibration). Some U.S. banks use single factor models and do not decompose their operating risks into specific types.

In our internal capital models, we draw a clear distinction between "event" and "business" risks. Event risk aligns closely to the Committee's definition of operational risk. Business risk is meant to capture the risk of losses associated with a poor business model or a rapidly changing business environment. In our internal models, event risk accounts for roughly 5% - 7% (at a 99.9% confidence level) of our entire economic capital base (approximately $13 billion) and business risk accounts for 12% - 15%. We theorize that many US banks lumped these risks together in their reporting of "operating risk" to the Committee as the combination of these two approximates the 20% calibration mentioned in the proposal. Accordingly, we feel the calibration is at least 3 – 4 times too high.

Second, there is verbiage in the proposal indicating the calibration was to ***Total*** minimum regulatory capital. This is confusing in that economic capital at most institutions should be closer to *Tier 1* capital. Using 20% of the 8% minimum yields operational risk capital of 1.6% of adjusted risk weighted assets (ARWA), which is excessive. This component of the calibration, along with the scope issue mentioned above, both make the operational risk capital benchmark too high. As of 12/31/00, the 1.6% of ARWA would push operational risk capital for First Union to $3.2 billion or 4 – 5 times higher than our internal measure of operational risk capital.

Third, there is nothing in the proposal that gives recognition of the low to zero correlation between many operational risks and other risk types. The Internal Measurement Approach (IMA) mentions this, but is not explicit in its description of how it will be reflected. All three approaches should have diversification reflected. This component should not be used as an incentive to move organizations toward the IMA.

Regarding the distinction between direct and indirect losses, we believe only direct, quantifiable losses should be used in the quantification of operational risk. Including costs to "fix" operational problems seems inconsistent with industry treatment of losses stemming from other risk types. For example, the costs of restructuring a poor underwriting process are not termed credit losses; the costs of retooling a VAR system are not termed market losses. Additionally, adding the costs to fix problems would give more efficient banks less capital and incent banks to minimize these costs rather than fully address problems. We discourage the inclusion of "near misses" and latent losses partly on the same grounds as above and also from the view that including these would make loss consistency from organization to organization even more difficult.

The Committee is open in its own criticism of the crudeness of the Basic Indicator Approach and we concur with their assessment. However, our main concern with this approach is not the crudeness of the measure, but the size of the "alpha" factor. We realize the 30% factor relates to the calibration to 20% of MRC but do point out that this would place First Union's 12/31/00 operational capital at approximately $4.3 billion - roughly 6 times our internal measure. We feel an alpha factor of around 5% - 7% would better reflect a firm's overall level of operational risk.

The Standardized approach is presented as a refinement to the basic indicator approach. The key improvement is that different indicators and capital factors (betas) are available for different areas of the bank. Being able to specify the business lines and indicators is an improvement but the Standardized Approach suffers from the same calibration problems mentioned above. Though no beta terms are provided in the proposal, we have taken the liberty of providing our view of reasonable business line betas. We base these on the business lines and indicators listed in paragraph 26 of the Operational Risk Consultative Document and our internal operational risk capital model.

Business Line	Recommended First Union Indicator	Beta Factor
Corporate Finance	Gross Income	4 – 6%
Trading and Sales	Gross Income	4 – 6%
Retail Banking	Avg. Assets	40 – 50 bps
Commercial Banking	Avg. Assets	20 – 30 bps
Retail Brokerage	Gross Income	8 – 12%
Asset Management	Assets Under Mgmt	2 – 4 bps

The Internal Measurement Approach represents the most sophisticated approach presented in the proposal and resembles a typical retail credit risk capital framework. It requires banks to estimate the probability of a loss event (PE) and the severity or loss given event (LGE). These terms are combined with supervisory provided "exposure indicator" and "gamma" term to set capital.

The Committee has asked for comments on possible exposure indicators and loss categories to use in setting capital. We believe the exposure indicators must be kept fairly generic to achieve consistency between organizations. The indicators presented in the descriptions of the Standardized approach are reasonable and simple but could be expanded to include various volume metrics (number of transactions, number of items processed, number of claims handled, *etc.*). Regarding possible loss categories, these too should be generic to maintain inter-bank consistency. Common categories such as processing failures, outages, settlement losses, merger related, litigation, internal fraud, external fraud, card related, errors and omissions, discretionary losses, and "other losses" should suffice.

The assumptions needed to convert an expected operational loss amount into capital include the shape of the loss distribution, the correlation coefficients between operational

losses, and the desired confidence level. Under the Internal Measurement Approach, each of these will be imbedded in the supervisory provided "gamma" term. Our internal analysis has demonstrated that the shape of the loss distribution varies by loss type. Accordingly, the gamma term should be different for each loss type. Gamma also needs to reflect the significant diversification benefits represented by the low correlations among operational risks and between those risks and other types of risk.

Finally, the Committee reports its desire to use industry wide data to derive its gamma term. Realizing that each organization is not equivalent in its business mix and control environment, we support a scaling factor concept (termed an RPI in paragraph 39 of the Operational Risk Consultative Document). We encourage the Committee to work with the industry in developing the framework and the scaling factors prior to the Accords' effective date.

SECURITIZATIONS

While providing precise details with regard to some aspects of securitization, the proposal is somewhat vague in its description of others. In order to provide additional insight the United States Federal Reserve Board put forth an additional document called "Considerations Regarding the IRB Treatment of Securitizations." Our comments are based on information from both sources.

The primary guiding principal in determining the regulatory capital treatment of securitizations (and indeed for the proposal as a whole) should be that equivalent risks should receive equivalent capital treatment. This has several implications for the treatment of securitizations. First, the total capital charge for the securitization should, to the extent possible, equal the capital charge for the underlying assets. We therefore disagree with the recommendation of the Federal Reserve that a multiplier be applied to the capital charge of the underlying assets as a way of insuring that investors receive a sufficient capital charge while insuring that originators hold a dollar-for-dollar first loss position.

We believe that any portion of the underlying risk that is taken on by investors represents a similar reduction in the risk held by the originator. The proposal should focus on the accurately accounting for this transfer of risk rather than the overly conservative approach of grossing up the capital charge. The Federal Reserve paper indicated that part of the reason for the multiplier was to account for instances where the capital treatment of the underlying assets was inaccurately low. Given that supervisors would have already approved of the internal rating systems of the originating bank, the possibility of a significant error in the capital calculation for the underlying assets would appear remote and would not seem to justify the need for a corrective multiplier.

In practice, the capital charge for the first loss position of a securitization should be determined by taking the total capital charge of the underlying assets and subtracting the capital charges for all other positions (whether determined by internal ratings, external ratings, or a formulaic approach). This will insure that banks that do successfully transfer

risk to other institutions receive the appropriate regulatory capital relief. Additionally, such an approach is consistent with the goal of the Committee to maintain current levels of capital within the banking system.

To the extent possible, the capital charges for originators, investors, and sponsors should be consistent with one another. The current proposal treats mezzanine positions as a direct credit substitute if there is a substantial first loss position held by a third party but as a deduction from capital if the first loss position and the mezzanine position are both held by the same bank. We believe that the goal should be to accurately assess the risk inherent in each tranche and then to consistently apply that capital charge to all participants.

Ideally, capital charges for securitizations should be based directly on banks' internal ratings. We believe that advanced practice banks are capable of accurately assessing the risks inherent in securitizations and rating the various portions appropriately. Supervisory review through Pillar II would be sufficient to assess the validity of such grades.

Short of a full internal ratings based approach, risk weightings based on external ratings are most appropriate. As is true for other aspects of the proposal, however, under the standardized approach there are too few buckets and the associated risk weights fail to reflect the underlying risks. While the proposal does not specify how risk weights will be mapped to external grades for the foundation approach, the implication is that such mappings will be much more reflective of the underlying risk. One question that must be resolved is how banks will qualify for the foundation IRB approach. For originating banks it is clear that they must first have been approved to use the IRB approach for calculating the capital charge for the underlying assets. For investor banks, however, the foundation approach does not rely in any way on internal ratings, so it is unclear what criteria would determine whether such banks are permitted to use the foundation approach.

First Union concurs with the concept that a bank that supports its securitizations has not effectively transferred risk. It should be understood, though, that certain circumstances may cause a bank to support a securitization and others may not. For instance, a servicing disruption may generate such support whereas a general decline in the economy may not. The requirement that a second instance of such support eliminates capital relief through securitization is overly harsh. First Union recommends that these remedies be available to supervisors under Pillar II, so that there be some judgment on their application. At worse, this rule should only be applied on an asset class-by-asset class basis. If this rule is adopted, there needs to be some guidance for reconsideration for banks that fall under this treatment.

The Committee has recommended a 10% conversion factor be applied to the notional amount of the off-balance sheet securitized asset pool in transactions with early amortization provisions. We oppose such a charge for two reasons. First, early amortization procedures represent a form of liquidity for the bondholders rather than constituting recourse to the bank that sponsors the securitization transaction. Furthermore, the terms and conditions of such provisions vary among transactions thereby rendering the imposition of a single conversion factor inappropriate.

GRANULARITY ADJUSTMENT

The granularity adjustment clearly reflects the Committee's efforts to incorporate economic capital concepts as much as possible within a regulatory capital framework. While generally achieving its purpose, the granularity adjustment as put forth in the proposal is somewhat complex and confusing. Further clarification of formulas and their implementation is needed. For example, are all non-retail risk weighted assets to be included in the adjustment? How are OTC derivatives handled? How are securitizations handled? Are securitizations of retail products handled differently from non-retail products?

While conceptually correct, the granularity adjustment in one sense could provide a disincentive for good risk management practices. The validity of the result depends in part on the ability of banks to aggregate highly correlated obligors as well as to include guarantees supplied by those obligors within the aggregation. Those banks that are skilled in tracking the relationships between obligors and can aggregate them appropriately will pay a higher price in terms of the granularity adjustment than banks that perform poorly at such aggregation.

ADDITIONAL ISSUES

We recommend that the Committee consider the diversifying effects of Credit, Market, and Operational Risk**.** The proposed accord indicates that operational risk is considered to be a significant part of overall risk. There is little reason, however, to expect significant correlation between it and Credit and Market Risk. Therefore, computing capital for each individual risk and summing the results provides an overly conservative estimate of total capital. Some form of correlation estimate or haircut is appropriate.

PILLAR II

Pillar II remains a vital part of the proposed accord. Attempts to fully characterize regulatory capital through the rules laid out in Pillar I would result in overly complex calculations and a regulatory capital that would not adequately reflect the underlying risks. As we have indicated, it is important that through Pillar II supervisors be given sufficient flexibility to facilitate the migration of banks from one regulatory capital approach to the next. In particular, supervisors should be permitted to approve the migration to more advanced approaches on both a portfolio-by-portfolio and an input-by-input basis.