Fleet

FleetBoston Financial

May 31, 2001

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002, Basel, Switzerland
bcbs.capital@bis.org

Re: The Proposed New Basel Capital Accord

Ladies and Gentlemen:

FleetBoston Financial Corporation ("FleetBoston") is a diversified financial holding company headquartered in Boston, Massachusetts, USA with consumer and commercial banking platforms, as well as asset management and capital markets businesses, serving approximately 20 million customers in more than 20 countries around the world. As of March 31, 2001, FleetBoston was the seventh largest banking company in the United States, with total assets of $212 billion, total deposits of $128 billion, total stockholders' equity of $20 billion, approximately 65,000 employees, and earnings of $3.2 billion in 2000.

The New Basel Capital Accord ("New Accord"), issued for comment on January 16, 2001, would have a significant impact on our institution and on the banking industry in general. As such, we appreciate the opportunity to provide the Basel Committee on Banking Supervision ("Committee"), along with our US banking regulators, with our thoughts and concerns about the New Accord.

FleetBoston, along with many other international banking organizations, is providing the Committee with additional comments via several industry-group comment letters, including, but not limited to, the Risk Management Association and Institute of International Finance. While we affirm the comments made on our behalf by industry trade groups, this letter will focus on those issues of primary concern to FleetBoston.

Risk-Linkage and Capital Neutrality

The Committee states the following two primary objectives in promulgating the New Accord:

> *"The new framework is intended to align capital adequacy assessment more closely with the key elements of banking risks and to provide incentives for banks to enhance their risk measurement and management capabilities."*[1]

> *"With regard to the level of overall capital, the Committee's primary goal is to deliver a more risk-sensitive standardised approach that on average neither raises nor lowers regulatory capital for internationally active banks."*[2]

[1] Paragraph 2, *Overview of The New Basel Capital Accord*, January 2001
[2] Paragraph 7, *Overview of The New Basel Capital Accord*, January 2001

FleetBoston commends the Committee for its attempt to improve the regulatory capital requirements based on these principles. We agree with the stated objectives for regulatory capital to become more closely related to the underlying economic risk profile of a financial institution and of initially maintaining a capital-neutral stance for the industry. In fact, over the past ten years, FleetBoston has maintained a risk-based or economic capital approach that has proven quite successful in the management of risk and the allocation of capital. However, based on our experience, it is our strong belief that the use of the computation methods proposed by the New Accord would result in a regime that falls short of achieving the stated goals.

While the New Accord would adequately provide for relative risk differentiation, it would push regulatory capital above the level required for the absolute level of economic risk, as both the FleetBoston internal economic capital model and the markets in which we operate measure that risk. For FleetBoston, we estimate a significant increase in minimum regulatory capital requirements, or said another way, a non-trivial deterioration in our regulatory capital ratios with no underlying change in our risk profile. This is a direct result of:

A. the conservative approach taken in the proposed computations of required capital for credit risk;
B. the addition of a specific capital charge for operational risk; and
C. the omission of a capital benefit for the positive effects of business-line diversification.

A. Credit Risk Capital is Too Conservative: The proposed loss given default ("LGD") parameters and the imposition of a capital floor based on these LGDs would, in our opinion, increase the capital requirements for many banks, at least for the two years following the New Accord's effective date.

The Foundation Internal Ratings-Based ("IRB") approach only allows the probability of default ("PD") to be supplied by the individual bank. Hence, the calculation of capital makes use of supervisor-supplied LGDs, approved collateral, and exposures at default ("EAD") that we believe would be unsupported by data and are overly punitive. The 50% and 75% LGDs for senior and subordinated lending, respectively, are in excess of our actual experience, which is closer to one half of the proposed levels. Letters from industry groups, which you will receive as part of the comment process, include surveys of banks' internal experience and will serve to corroborate this view for many internationally active banks.

With regard to collateral, the Foundation IRB approach only allows financial instruments and real estate to reduce LGDs. Other forms of protection provide no relief. If implemented as proposed, this would severely weaken the competitiveness of bank lending to middle-market companies. Security interests—such as accounts receivable, inventory, machinery, and equipment—are treated as unsecured obligations with a 50% LGD and consequently provide little loss reduction in the regulatory framework. Actual experience at FleetBoston, going back to 1990 and including severe economic downturns, shows this to be much too conservative.

The Foundation IRB approach is also inadequate in its recognition of the diversification benefit, or lack thereof, within commercial credit-risk portfolios. The New Accord includes a "granularity" adjustment designed to capture the "lumpiness" or homogeneity of the size of exposures. The cross-industry diversification benefit, however, is assumed to be the same for all banks and uses an average correlation coefficient of 20%. We feel this "one-size-fits-all" approach would penalize FleetBoston, especially our middle-market business line where the portfolio is well-diversified and whose obligors show little correlation with one another.

Consumer assets are also impacted by the Foundation IRB approach. The New Accord's provision to hold capital for expected losses contravenes traditional financial theory that suggests that expected losses be recognized through current period earnings and capital be held for unexpected or catastrophic events. This leads to higher-than-necessary levels of capital and would significantly undermine the competitive market position of companies subject to the New Accord. In addition, it argues against the long-held theory of matching current losses against current revenues. As a result, the New Accord would severely penalize consumer assets, especially credit card, where the expected losses are high relative to the unexpected. Banks charge expected losses against income as a "cost of doing business" and, therefore, do not hold capital for them.

For those banks that would use the Advanced IRB approach, which allows the use of internal assessments without supervisory overrides to the inputs, the shortcomings of the Foundation IRB approach would not seem to matter. However, the Committee intends to impose a floor for the first two years indicating that the "capital requirements for credit risk resulting from the advanced treatment will be subject to a floor of 90% of the institution's capital requirements for credit risk that would result under the foundation approach."[3] Not only does this burden the users of the Advanced IRB approach by essentially requiring two capital computations, but more importantly, it also severs the link between the regulatory capital requirements and the underlying economic risks. This disparate treatment also creates unfair and unintended economic competitive disadvantages.

For all the reasons above, FleetBoston strongly urges the Committee to adopt the Advanced IRB approach without any specific supervisory minimums for the major inputs or any floor levels on the resulting capital levels. This will more closely align the Committee's goals for the New Accord with its proposed method of determining minimum credit-risk capital. It is our view that this would also motivate less-sophisticated banks to move towards a more robust risk-management framework.

Our recommendation is largely based on the following reasoning. Supervisory review and validation of bank models is a prerequisite for the use of internal models for regulatory capital calculations. We believe this to be the appropriate point at which discussions of assumptions and data calculations should take place. It should not be assumed, *a priori*, that the inputs need to be made conservative using rule-based procedures. If during the validation process examiners conclude that a bank has not shown proper back-up for its inputs, they can require additional conservatism in the parameters. The advanced approach, is by its nature, the best method to assess economic risk. Arbitrarily constraining the results of such risk assessment would seem to send an incorrect message to bank management and may invite some arbitrage between the two methods of the New Accord.

B. A Specific Capital Charge for Operational Risks is Excessive: As currently written, the New Accord's proposal for new operational risk capital would increase required capital, all else being equal, no matter how the methodology is defined. We support the Committee's desire to develop a methodology for operational risk, but believe that the current state-of-the-art for operational risk measurement has not progressed sufficiently to warrant its use in the assignment of a minimum regulatory capital charge.

Operational risk is an emerging area of research, risk assessment, and capital adequacy assessment for the industry and its regulatory authorities. Several important activities are underway:

- Definitions are being standardized to avoid a double-count of losses with credit and market events.

[3] Paragraph 162, *The New Basel Capital Accord*, January 2001

- Data on the history of loss events is being gathered at individual banks and for the industry in total.
- Quantitative models are being developed to analyze the data.

Most banks view the cost of operational risk as a "cost of doing business" to be covered through current operating earnings. Banks have made a significant investment in risk mitigation costs, such as establishing and maintaining risk-control systems, internal and external audit oversight, and insurance protection. Traditionally, losses are charged directly against earnings as they occur or a reserve is established for potential future losses. In fact, we struggle to find any example where any company covered by the New Accord had an operating loss that materially impacted its capital, much less to the level suggested by the New Accord. In summary, the amount of capital proposed under the New Accord for operational loss far exceeds any possible loss attributable to an unexpected or catastrophic event.

FleetBoston strongly urges the Committee to remove the explicit capital charge for operational risk from Pillar I and to incorporate the assessment of this risk type under Pillar II, Supervisory Review. This recommendation stems from the general lack of agreement on the conceptual framework and the view of the risk being one to earnings not to capital.

Our recommendation is not without precedent. The assessment of interest rate risk has been around much longer than operational risk and has been the explicit cause of a number of bank failures in the past. The measurement processes are very well-developed and have undergone extensive scrutiny by the industry, the supervisors, and academicians. All would agree there is some level of economic risk here, but the Committee has decided, and we strongly agree, that this risk is better handled within Pillar II.

FleetBoston also urges continued collaboration between the industry and the bank regulatory authorities in advancing risk assessment techniques for operational risk.

If, however, the Committee decides to continue with a capital charge for operational risk, we ask for postponement of implementation until significant refinement to the three approaches can be made. In general, there seems to be very little evidence to support the Basic Indicator approach's capital to be 30% of gross income or the Standardized Approach's calibration of operational risk capital to 20% of minimum regulatory capital. Implementation of the New Accord's proposed provisions for operational risk would mean a significant increase to the capital of subject banks without any clearly demonstrated link to risk.

We also suggest a technique from credit-risk capital be used, i.e., to provide a benefit for mitigation actions. For operational risk, these come in two forms: (1) strength of the risk-control environment and (2) the purchase of insurance. The capital requirements, therefore, should be commensurate with the levels of these two items.

C. The Benefit of Line-of-Business Diversification is Ignored: Nowhere in the New Accord is there a capital benefit provided to banks that operate a diverse mix of businesses. Business-line diversification mitigates capital-loss risk and banks should be allowed a credit or other benefit to recognize this factor. The source of this benefit is the small chance of a bank experiencing significant losses in each of its businesses at the same time. For example, the New Accord would determine capital for a bank operating only two business lines—consumer banking (primarily a credit-risk activity) and asset management (primarily an operational-risk activity)—as the simple addition of credit-risk capital and operational-risk

capital, computed independently. We feel this overstates the institution's total risk, as well as sends an inappropriate message that diversification of risk provides no greater benefit than concentration of risk**.**

We offer two primary arguments in support of the benefit. First, FleetBoston developed internal estimates of the capital reduction that comes from its existing mix of business. The results demonstrate that business line diversification allows FleetBoston to reduce its economic capital by more than 20% from the levels that would otherwise be required. In our discussions with external rating agencies, they acknowledge that diversification is an inherent risk mitigant and is reflected in their ratings of financial institutions. For example, monoline credit card companies are viewed as riskier than well-diversified financial institutions, all else being equal. This can be seen clearly by the higher levels of capital required by the markets for concentrated businesses.

FleetBoston strongly suggests that, at the total bank level, any final rule must include a reduction in regulatory capital for the benefit of line-of-business diversification. In order to accommodate this change, a sliding scale could be developed using the businesses outlined in the operational-risk proposal. The following provides a simple approach to providing benefits:

> In the consultative document, there are nine Level-1 business units.[4] To qualify for any decrease, an institution must first have at least two business units that each contribute at least 10% of the bank's annual pre-tax net income. This would set a base reduction in the amount of 6% of the aggregate regulatory capital. For each additional business that contributes at least 10% of annual pre-tax net income, an extra 1% reduction in regulatory capital would be provided. Therefore, a monoline bank receives no diversification benefit, while those with two to nine businesses can have total regulatory capital reduced by an amount ranging from 6% to 13%. While conservative correlations of 0.75 were assumed in creating the preceding example, it is meant to suggest a framework to quantify a benefit we feel is warranted and substantial.

Unintended Consequences of the New Accord

The Committee's objective that the New Accord maintain capital neutrality for the industry is potentially unattainable. Credit-risk capital that is subject to overly conservative floors, the new operational risk capital charge, and the lack of a diversification benefit would, we believe, lead to a rise in the industry's required levels of regulatory capital, especially for those banks using the IRB approaches. Capital increases, coupled with rules that are not directly linked to economic risks, could have the following consequences:

> ***Uneven Competitive Playing Field***: As with the current regulatory capital regime, the New Accord applies only to banking firms. This would leave non-bank competitors free to pursue their business activities unencumbered by supervisory capital rules. We feel this could result in assets or business activities flowing from the banking system to more capital-friendly entities. This hurts bank earnings potential, making them more susceptible to downturns. With the potential for so many activities to be conducted outside the banking system, the national regulators' ability to control systemic risks is greatly reduced.

[4] Annex 2, page 19, *Operational Risk—Supporting Document to the New Basel Capital Accord*, January 2001

Another potentially adverse competitive element of the New Accord relates to interpretations. It appears that supervisors in each country are allowed wide discretion to interpret the New Accord as they will. This could lead to banks in a particular country operating under a more favorable version of the capital rules, which would provide them with a distinctly competitive advantage. Therefore, we urge a standard and uniform interpretation of the proposed rules by all regulatory agencies.

Increasingly, we find our competitors are non-banks or non-U.S. banks. It is critical that consistent economic forces be measured in an even and fair manner so as to prevent a significant weakening of the U.S. banking industry.

Pro-Cyclicality**:** As economies head into the downside of the credit cycle, obligor ratings will deteriorate causing banks to hold more regulatory capital. This, in turn, will cause the tightening of credit standards and potentially lead to a shortage of credit availability just at a time that credit becomes increasingly important in turning around the economy. The New Accord should seek to reduce the volatility of cyclical economic changes. This can be accomplished by removing the floor for Advanced IRB banks, which leads to a more economic assessment of the underlying economic risks.

Capital Arbitrage**:** If banks have to hold more regulatory capital and potentially more GAAP capital, the New Accord's process would become much more important to marginal decision-making. Institutions would continue to explore opportunities for regulatory capital arbitrage because the rules are de-linked from the economic risk as measured in the market. Therefore, rather than removing the incentive to engage in arbitrage activities, the New Accord would only provided a new set of opportunities.

Other Concerns with the New Accord

Regulatory Capital for Expected Losses: The underlying assumption that regulatory capital also covers expected losses is of great concern. Typically, economic capital is for protection against unexpected losses. In fact, economic capital protects against the volatility of actual losses around an average or expected level.

Expected losses are a "cost of doing business" that is charged against income as incurred or via a provision to build a reserve. To require capital for expected losses seems to suggest that actual charge-offs should be charged against capital, not earnings. If this were so, then banks would be freed from the need to charge these losses against earnings, as they have already set aside capital.

FleetBoston suggests that the regulatory capital methodology be reevaluated to cover the potential for unexpected losses only. If the Committee continues to pursue the approach of covering both loss-types, we suggest that (1) all of the reserves be included as regulatory capital and (2) some method be developed to provide a capital reduction for an institution's earnings power.

Equity Investments: Equity investing is a major line of business for FleetBoston that has at times made significant contributions to earnings. This, coupled with the U.S. agencies' proposal for capital assessments on these investments, creates particular interest for us in the ultimate treatment of this asset class. The current proposal seems incomplete. If our interpretation of the proposal advocating a

100% capital deduction of the investment, once it reaches certain materiality thresholds,[5] is correct, this seems very onerous. We would suggest an effort closely coordinated with the U.S. bank regulatory agencies that have a proposal for capital treatment of so-called "merchant banking investments." If additional capital is to be held for these investments, then any unrealized gains should be included as a component of regulatory capital.

As stated further in the consultative document, the Committee is considering one of two methods for the determination of regulatory capital for equity investments. They are (1) a probability of default / loss given a default approach similar to the treatment of corporate debt and (2) a market risk or stress test approach.[6] Depending on the details of the methodology, each approach could have merit as a useable capital framework. Internally, we use a market-risk approach for the determination of economic capital.

FleetBoston recommends that the Committee remove its "blunt instrument" approach of 100% deduction. Instead, we urge an effort, coordinated with the banking industry, to develop a more risk-sensitive and economically-based methodology.

Incentive Compensation: The suggestion that the probability of obligor default ("PD") be included as an element of incentive compensation plans is well beyond the scope of regulatory capital pronouncements.[7] Development of strategic plans and the compensation of managers are the purview of bank management and not an issue for regulatory rule-making. Granted, a component of any decision involves an analysis of the return on the risk taken and, hence, PDs enter into the calculation of economic equity like many other factors. To single out one element of the assessment process, however, seems inappropriate.

The 'w' Factor: We wholeheartedly endorse the Committee's attempts to provide regulatory capital relief for credit mitigating instruments, such as guarantees and credit derivatives. However, the need to put a floor under the benefits of these activities, denoted by the 'w' factor, is unclear to us. There does not appear to be any theory for the concept or any analysis to support the proposed 15% level. In fact, it appears that an extra layer of conservatism is being applied to guarantees and credit derivatives. Therefore, we strongly recommend that this factor be removed from the New Accord.

Asset Securitization: Deducting the entire first loss position from regulatory capital—even when it may exceed the capital required for the assets if they were retained on balance sheet—seems onerous. Securitization of assets is an important liquidity management tool for banks since it represents funding without own-name event risk. The New Accord's treatment of first-loss positions may jeopardize its effectiveness and lead to an increase in liquidity risk. Our view is that capital should first be determined for the securitized assets as if they remained on the balance sheet. The capital then should be the lesser of this amount or the total retained first-loss position.

A great improvement over the current rules, and one that FleetBoston strongly supports, is the use of an IRB approach for tranches of a securitization purchased as an investment. This is especially

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[5] Paragraphs 16 and 17 from *The New Basel Capital Accord*, January 2001
[6] Discussed at length in Chapter 6 (specifically beginning with paragraph 384), *The Internal Ratings-Based Approach—Supporting Document for the New Basel Capital Accord*, January 2001
[7] Paragraph 295, *The New Basel Capital Accord*, January 2001

important for externally-rated securities, as the market uses the debt ratings to price the securities for the appropriate level of risk.

Oversight role of board of directors must be clarified: The New Accord's discussion of the role of the board of directors in the capital process should be clarified to allow for appropriate delegation of authority to management to design, implement and manage the capital program. Our view is that the board's role should be confined to ensuring that management takes all reasonable steps necessary to assess the risks and to assign the appropriate amount of capital. It is a role of oversight, not risk assessment. It would be unreasonable to expect the board to opine on the merits of various technical capital methodologies. Instead, the board should assess and oversee management's capacity to adequately assess the risks.

Expectation for banks to operate above minimums is unfair: We are concerned about the potential for examiner discretion afforded by the statement in Pillar II about operating above the minimum regulatory ratios. The vaguely worded statement alludes to an expectation that banks will maintain capital levels well in excess of the minimum standards. While in practice this is often the case, the statement is unsettling because it would empower an examiner to set a "minimum" standard that is higher than that set forth in the regulation. The result will be an uncertainty as to the how much above is enough and how this would be determined. Most banks maintain a cushion above their minimum capital levels in order to conduct business with their target client base. That cushion should be determined by management after gauging the demands of the market, and not by examiners. A bank's primary regulator will always maintain adequate authority and have ample opportunity to impose higher capital standards on any particular bank that poses supervisory risk. The regulation must delineate minimum standards to which banks can adhere with impunity.

Disclosure Requirements are Unworkable: The New Accord requires that a bank make extensive additional disclosures about its risk profile and risk management processes. These disclosure requirements are fundamentally flawed and should be dropped from the proposal for several reasons. First, the additional disclosures will not achieve the intended effect of increasing market oversight of financial institutions. The market is sufficiently well informed already as evidenced by the size of the market for debt issued by financial institutions. A financial institution transacts business daily in a variety of capital markets by raising wholesale funding, issuing debt, and providing clients with risk-management products. All of these transactions require the market to constantly assess the financial institution's creditworthiness, including but not limited to, its capital structure. Market participants have ample opportunity and resources to evaluate credit risk with the information already in hand. If the market needs more information, it will demand it. We do not believe the Committee has any unique insight into additional information that may be required by the market to make the same credit decisions it makes today without these disclosures.

The disclosure requirements may also create additional securities law liability for financial institutions that are subject to U.S. securities laws. Capital reserves represent an implied view of future expected losses. Any required disclosure of a bank's assessment of its capital position is, by its nature, a "forward-looking statement" which private litigants could use to bring suits under U.S. securities laws with the benefit of "20/20 hindsight." While securities laws provide some safe harbors that may mitigate this risk, it cannot be eliminated. This litigation liability would not accrue to financial institutions that are not subject to U.S. securities laws. Ultimately this would represent a competitive advantage for those institutions.

We also believe that forced disclosure of much of a bank's risk profile represents an unfair compromise of confidential, proprietary business intellectual property. The disclosure requirement may also result in a constriction of credit availability to less creditworthy customers. Banks would have an added incentive to avoid extending credit to any borrower that could trigger a further disclosure of increasing risk positions.

Finally, complying with the disclosure process detailed in the New Accord would be quite burdensome. Much of the information exists in formats designed for internal use and access. To translate and transmit the data would require additional staff and systems to ensure that the data is available, easily understood, and kept current.

Conclusion

These comments and those of our trade member organizations represent our best effort to assess the implications of this significant amendment to the regulatory capital rules. The proposed New Accord would result in a significant change for the banking industry; changes that will take more time to fully assess. We ask that the rulemaking process be slowed to allow for sufficient analysis of the impact of these proposed modifications to a capital regime that has served regulators and the industry well for over two decades. We further request that any new rules be implemented on a schedule that would allow adequate time for the industry and the markets to prepare for the changes.

We commend the Committee for its efforts and trust that it will take into consideration the many positive suggestions offered by the industry as it crafts the final version of the New Accord. The banking industry will willingly work with regulators to arrive at a set of economically robust capital rules that will provide the appropriate economic incentives to develop a safe, sound, and competitive banking system.

FleetBoston is prepared to provide further input to the Committee's deliberations on this topic. Please contact William Schomburg (617-434-6158 or *william_h_schomburg_iii@fleet.com*) or myself (617-434-9391 or *eugene_m_mcquade@fleet.com*) with further questions or comments.

Sincerely,

/s/ Eugene M. McQuade

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