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Federal Reserve Board
Basel 2001 Capital Proposal, Mailstop 179
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Washington, DC 20551

Office of the Comptroller of the Currency
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Independence Square
Washington, DC 20219

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

**Re: Comments on the Proposed New Basel Capital Accord**

JP Morgan Chase & Co. is pleased to provide comments on the Basel Committee on Banking Supervision's (Committee) consultative document, the New Basel Capital Accord (New Accord). Through its consultative process, the Committee has created a unique opportunity for internationally active banks and supervisors to have a constructive dialogue about the appropriate evolution of regulatory capital requirements. We greatly appreciate the Committee's receptivity to the banking industry's comments on the June 1999 consultative paper regarding a new capital adequacy framework. As a result, the proposed new capital regime is much more risk sensitive than the current regime and provides some important incentives for better risk management and measurement. We also greatly appreciate the effort supervisors have made since the release of the latest proposal in mid-January to explain various features and to seek input from the industry.

After the executive summary, we begin our comments by discussing four principles we hope the Committee will keep in mind as it proceeds with the finalization of the New Accord. We then comment on calibration issues related to the Pillar 1 capital requirements. In the third section we comment on the specific requirements for credit risk. We discuss the treatment of operational risk in the fourth section, including the relationship to credit risk. In the fifth and sixth sections we comment on the supervisory and market discipline pillars of the proposal, respectively. Finally, we briefly discuss the relationship of the leverage ratio in the United States to the new capital framework.

**Executive Summary**

- Ultimately, the best way for the Committee to ensure that regulatory capital reflects the true dimensions of a bank's risk profile is to allow the full use of internal models. In this regard, we welcome the internal ratings approach, especially the advanced approach, which allows banks to rely on their estimates of probability of default, recovery rates, and exposure amounts. (Section 1.2)

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- The proposal incorporate highly detailed minimum qualification requirements for the internal ratings approach. Although we support the idea that firms should demonstrate sound practices in order to take advantage of advanced alternatives, we are concerned that the level of detail is too great, encroaching on management discretion. (Section 3.1 and Appendix 2)
- The calibration for the internal ratings approach is too conservative for a minimum regulatory capital standard, primarily as a result of a multiplier in the risk weight formula. The calibration for retail assets is particularly onerous due to the multiplier and conservative assumptions about correlations. The Committee should eliminate the multiplier and adjust other parameters so as to set the prudential standard consistent with a low investment grade rating. The Committee should recognize correlations across risk types. (Sections 2.2-2.3, 3.5, and Appendix 1)
- The Committee should require capital to be held for unexpected losses only. If the Committee decides to include both expected and unexpected losses, it should broaden the definition of capital to include reserves for expected losses and certain highly predictable income streams where pricing is designed to capture expected losses. (Section 2.1)
- The W factor is not justified and should be eliminated. Inclusion of the W factor will misalign risk and regulatory capital, will adversely affect the financing and credit derivatives markets, and will discourage the use of credit risk mitigation techniques by banks. (Sections 1.2-1.4, 3.7.2, and 3.8.3)
- The proposal does not fully recognize the reduction in risk due to credit hedging because it only shifts the risk weight of the exposure to the credit protection provider. As a result, the proposal does not recognize the lower risk of joint default. The Committee should adopt a simplified framework for recognizing different correlation levels to correct this. (Section 3.7.3)
- We welcome the broadened recognition of collateral and the opportunity to use our own haircuts in the advanced internal ratings approach. However, the proposal is unduly conservative in that it does not recognize correlations between collateral and the exposures. The Committee should allow banks to take a portfolio approach to collateralized transactions, including adjusting the assumed exposure period to reflect market practices. The Committee also should recognize physical collateral in the New Accord. (Sections 3.8.4-3.8.6 and 3.8.9)
- The proposal on asset securitization has the potential to better align risk and regulatory capital. The Committee should allow banks to use either external ratings or internally developed ratings to establish capital at all levels of securitization structures. The risk-weighting scheme treats asset securitizations less favorably than corporate assets with comparable ratings. Such uneven treatment is not justified by historical performance and should be corrected. (Section 3.10)
- We welcome the Committee's initiative to include measures for operational risk in the scope of the New Accord. In developing the specifics of the measures the Committee should ensure that they are risk-based, transparent, scalable, flexible, and fair. At this stage in the development of the techniques for operational risk measurement, the Committee should avoid undue complexity in the regulatory calculation. Notwithstanding this preference, the New Accord should not treat operational risk in a linear fashion as scale increases. Moreover, the rules should incorporate qualitative adjustments for the control environment and should reflect the benefits of risk mitigation and transfer. New capital rules for operational risk should not impose an undue reporting burden on banks. (Section 4)

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- The Committee's disclosure proposals should be scaled back dramatically. The extensive disclosure requirements would not necessarily bolster market discipline and are inconsistent with recent recommendations from two high level working groups. Also, the new requirements would place banks at a competitive disadvantage relative to non-bank competitors. (Section 6)
- In conjunction with the implementation of the New Accord in the United States, the leverage ratio should be eliminated for US bank holding companies and banks. (Section 7)

**1. Principles for a New Capital Adequacy Regime**

We continue to strongly support the Committee's objectives to improve the way regulatory capital requirements reflect the underlying risks, to better reflect advances in credit risk mitigation techniques in the capital regime, to elevate the value of the supervisory process in assessing capital adequacy, and to foster greater market discipline. Moreover, we continue to believe that the three pillars of minimum capital requirements, supervisory review of capital adequacy, and market discipline provide a solid framework in which to address safety and soundness issues in an environment of continuous innovation in the financial markets. Some aspects of the proposals, however, tend to undermine these important objectives. Establishing a set of principles on which to base enhancements to the proposal could help the Committee achieve its objectives.

**1.1 Transparency**

In its comments on the June 1999 consultative paper the banking industry encouraged the Committee to be more explicit about the parameters it was using to establish Pillar 1 capital requirements. The motivation for the industry's comments is the lack of a transparency in the 1988 Basel Capital Accord (Current Accord). We welcome the Committee's efforts to be clearer about the parameters used to set the credit capital requirements under the new proposal, e.g. 99.5% confidence level, one-year time horizon, and 0.20 asset correlation. We observe, however, that the Committee has included a multiplier of 1.5 in the risk-weight formula for the new internal ratings approach. The Committee also has included a "W" factor for so-called residual risks, which are ill-defined in the proposal. We strongly encourage the Committee to eliminate those features of the proposal that are not explicit and that are not linked to any measurable risks banks can manage. If the Committee wishes to achieve a certain prudential standard in Pillar 1 capital requirements, it should do so by setting clear parameters that make the requirements easy to understand and to manage.

**1.2 Risk Sensitivity**

Transparency, in turn, has a direct impact on the actual risk sensitivity achieved in the proposal. The proposal goes a long way towards making regulatory capital requirement more risk sensitive than the current rules, particularly through the internal ratings approach to credit risk and the broader recognition of collateral. We are concerned, however, that some features of the proposal undermine this highly positive development. For example, the combination of the W factor and the lack of recognition of a double default benefit in credit derivatives results in an overstatement of the risks for banks hedging with these instruments. Also, it is unclear at this juncture whether operational risk capital requirements will be truly sensitive to a bank's risk management and control environment. We are especially concerned that the Committee has stated an expectation that operational risk capital would be approximately 20% of a bank's total capital requirement. We believe regulatory capital and internal economic capital should respond the same

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way to increases and decreases in risk, though not necessarily to the same degree. We encourage the Committee to follow this precept in further developing the proposal.

Ultimately, the most effective and efficient way to reduce the divergence between regulatory rules and market practice is to allow banks to fully utilize their internal models in the process of measuring their regulatory capital requirements. For banks that demonstrate they have a robust risk management and measurement process, this would provide the best way for supervisors to ensure that regulatory capital reflects the true dimensions of a bank's credit risk, including credit quality, maturity, correlations and concentrations. Similarly, allowing banks to use their internal models for operational risk would be the most effective way for supervisors to ensure that the regulatory capital framework captures the full scope of banks' operational risks as well as the compensating control environment. The Committee recognized the value of leveraging banks' internal models in adopting the Market Risk Amendment to the Current Accord. We believe that a full internal-models approach to credit and operational risk capital requirements is where the Committee should be headed. Recognizing that supervisors are not prepared at this stage to fully endorse the use of credit or operational risk models, we welcome the advanced internal ratings approach, the granularity index, and stage three of the operational risk framework as significant steps in that direction.

**1.3 Symmetrical Treatment of Products and Risks**

The regulatory capital regime should treat instruments and techniques with similar economic characteristics in a similar fashion. In this way, bank portfolio and risk managers can select the most efficient methods for managing the bank's risk profile. Symmetrical treatment also reduces incentives towards regulatory arbitrage, thereby avoiding distortions in the marketplace. Again the W factor, which applies to credit derivatives but not to bank guarantees, provides an example of asymmetrical treatment of products. Another example is the more favorable risk weights afforded corporate exposures compared to similarly rated asset securitizations, even though recent studies show that the latter may, in fact, be less risky, particularly at higher rating grades (see Section 3.10 below). We hope the Committee will ensure that the true economics of an instrument or technique ultimately determines its regulatory capital treatment.

**1.4 Incentives for Better Risk Management**

We support the Committee's desire to provide incentives to banks to improve their risk management and measurement. The internal ratings approach is designed to reward those banks that have invested in more advanced credit risk analysis techniques. Similarly, stage three of the operational risk capital requirements is intended to provide an advantage to firms that have made significant progress in applying advanced methods to their assessment of operational risk. Some aspects of the proposal, however, appear to be inconsistent with the Committee's stated intention. For example, by not recognizing the full benefits of credit derivatives, as mentioned above, the Committee is not creating the proper incentives for banks to use this highly effective form of credit risk hedging. Unfavorable regulatory treatment would be particularly unfortunate at a time when market participants have been making great progress in developing a more liquid market for these instruments. In addition, the standardized approach is more favorable than the internal ratings approach in some areas. For example, the standardized risk weights for lower rated assets are significantly lower than the risk weights for comparable ratings under the internal ratings approach. With the benefit of the industry comments, we hope the Committee will identify and correct those features of the proposal that undermine the incentives towards better risk management and measurement, which the Committee is rightly trying to create.

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**2. Calibrating Pillar 1 Capital Requirements**

Calibrating Pillar 1 capital requirements involves many important choices and issues, including, among other things, defining the scope of coverage, setting key parameters, and specifying the treatment of diversification and concentration effects. We comment on each of these three main areas below. Overall, we believe the Committee has made conceptually sound choices regarding the basic methodologies for the internal ratings approach and the more advanced stages for operational risk capital. We appreciate the effort the Committee has made in understanding banks' approaches to economic capital in both areas.

**2.1 Scope of Coverage**

The proposal states that Pillar 1 capital requirements are meant to cover both expected and unexpected losses. For internal economic capital purposes we apply equity capital to cover unexpected losses. We use other approaches to ensure we are properly capturing expected losses such as setting loan loss provisions in the wholesale credit portfolio and pricing and provisioning in retail portfolios. We suggest that the Committee design regulatory capital requirements to cover unexpected losses only because it would be a cleaner approach, would conform with the way most banks think of capital, and would allow for flexible approaches to the treatment of expected losses. If the Committee were to go in this direction, it would be appropriate to require banks to meet their capital requirements through Tier 1 capital only, provided the solvency standard were set at a reasonable level in line with clearly identified parameters. We recognize that such an approach raises issues related to the current definition of capital in the numerator of the capital ratio and that some appropriate transition rules would be required.

Should the Committee decide that risk-weighted assets are to reflect both expected and unexpected losses then it would be necessary for the Committee to revisit the definition of capital anyway. Specifically, the Committee would have to remove the current cap on loan loss provisions and incorporate an appropriate way of including highly predictable income streams in Tier 2 capital, particularly for retail portfolios. Moreover, the Committee would have to ensure that the risk-weighting scheme and capital formula would not disadvantage banks if they were to take specific provisions for portions of extremely low quality or defaulted assets. The Committee should not require capital to be held for assets where banks have already established an adequate financial cushion.

**2.2 Setting Key Parameters**

Regulatory capital requirements should be true minimum standards for safety and soundness and should not substitute for banks' own assessment of their internal economic capital requirements. Accordingly, in calibrating Pillar 1 capital the Committee must ensure that the regulatory standard is not unduly conservative, thereby confusing the capital allocation optimization process that should be the primary responsibility of bank management. The Committee has stated that in the calibration of the internal ratings approach it used a one-year loss horizon, a three-year maturity, a confidence interval of 99.5% (essentially a BBB standard), a 50% Loss Given Default (LGD), and an assumed asset correlation of 0.20. We believe these are reasonable assumptions for a minimum regulatory standard.

We are concerned, however, that the inclusion of a multiplier in the formula for the internal ratings approach is unduly conservative. Overall, the multiplier has the effect of pushing the minimum standards for credit risk towards the equivalent of an A rating category. We believe such

a minimum standard is inappropriate, especially in light of the fact that under prompt corrective action rules in the United States US banking organizations effectively have to operate significantly above minimum capital requirements to maintain their status as well-capitalized institutions. The Committee has cited banks' credit risk measurement errors, in large part, as a rationale for the multiplier. We do not believe there is any justification for the Committee to assume a systematic underestimation of risk by banks in the calibration of Pillar 1 capital requirements. The combination of our internal checks and balances, rating agency reviews, analyst/investor perspectives on our performance, and supervisory assessments works to prevent biases in either direction. If a supervisor is concerned about a bank underestimating its credit risk it should address the matter as part of Pillar 2.

**2.3 Diversification**

As proposed, the New Accord would continue to simply add credit, market, and operational risk capital requirements to arrive at the total requirement for the firm. In an economic capital framework, however, it is essential to include the impact of diversification across risk types. Within business activities, the Committee includes the benefit of diversification for both market risk (within the value-at-risk or VaR measure) and credit risk (because the credit risk capital includes benefits for portfolio diversification). It is also essential to include the diversification impact across business lines, which is not yet incorporated in the regulatory capital framework. We believe that firms that can demonstrate a robust methodology for incorporating such diversification in their economic capital models should be able to do so for regulatory purposes as well. Please see Appendix 1 for a discussion of an internal simulation we conducted that demonstrated the benefit of diversification across business lines.

**3. Internal Ratings Approach to Credit Risk Capital**

**3.1 Entry Criteria**

We support the idea that banks should meet certain qualification requirements to be eligible for the internal ratings approach. Such requirements would help ensure that only the most capable firms were able to take advantage of more sophisticated techniques and would help level the playing field among those eligible banks. Many of the requirements in the proposals appear reasonable and generally reflect banks' current practices. Accordingly, our specific comments only address the issues and questions we have with respect to the draft requirements.

We collaborated with staff of the International Swaps and Derivatives Association (ISDA) and another large internationally active bank in drafting the detailed comments for the ISDA response. For convenience, we have included an edited version of those comments, which address this portion of the proposal, as Appendix 2.

**3.2 Maturity**

We believe it is important for banks to have the option to use maturity as a risk driver in the regulatory capital calculation, including as part of the internal ratings foundation approach. We have no strong view on the choice of the method for making the maturity adjustment (mark-to-market or default only). We note that if the Committee decides the maturity adjustment should be based on the mark-to-market approach then the adjustment factor in the capital function of 1.35 would be appropriate; if the Committee chooses the default only mode our calculations indicate an adjustment factor of 1.15 would be more reasonable.

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We recommend other modifications to the Committee's proposal. Specifically, we believe banks using the advanced approach should be able to make their own adjustments to capital for maturity, reflecting their internal approaches to ratings transitions and repricing. In this regard, we recommend that the Committee not limit the maturity adjustment to seven years. Banks using either internal ratings approach should be allowed to incorporate risk weights for maturities of less than one year, if available. Also, for some asset types (e.g. asset-backed securities) where there is a statistically predictable flow of pre-payments, it would be more appropriate to use behavioral maturity rather than contractual maturity, as proposed. Finally, there should be

**3.3 Exposure at Default**

We welcome the opportunity under the advanced approach for banks to establish their own exposures at default (EAD), subject to supervisory review. Under the foundation approach, however, there is a requirement that commitments receive a credit conversion factor of 75%. We have recently conducted a study titled Loan Equivalent Exposures (LEQs) for Revolving Credits and Advised Lines,[1] the results of which indicate that a single, high exposure at default assumption would not be appropriate. For your information, the study concluded the following:

- LEQs for revolving credits (RCs) average 43% across all rating and time-to-default measures.

- LEQ's show a highly significant increase relative to time-to-default across all ratings categories. One-year RC LEQs average 32%, while 5-year LEQs are 72%. This may be due to a rating migration effect and a greater opportunity to draw down and implies that LEQs should be tenor adjusted in credit models.

- LEQs generally decrease as credit quality worsens, although unlike the time-to-default relationship, this is not as robust. An explanation may lie in tighter covenants and cutbacks in commitments for poorer ratings. In general, LEQs for BBBs and better average 62%, 48% for grades between BBB- and B+ and 27% for B and worse.

We would be happy to discuss this study with you with a view towards developing alternatives to the current proposals for EAD in the foundation approach.

**3.4 Floors**

Two floors imposed in the internal ratings approach cause us concern. The first is the requirement that for the first two years following implementation the capital required under the advanced approach cannot fall below 90% of the capital required under the foundation approach. We see no rationale for imposing such a floor. If a supervisor has conducted a thorough review of a bank's ratings process and capital allocation methodology, and has concluded that the bank is ready to implement the advanced approach, then the supervisor should be willing to accept the resulting calculation of <u>minimum</u> capital requirements. To impose such a floor would result in our having to calculate our regulatory capital twice quarterly over a two-year period -- at a multi-million dollar cost -- with no compelling safety and soundness benefit. It is by no means a trivial task for a banking organization of our size to recalculate our regulatory capital requirements for changes to key inputs. Among other things, data capture and control, detailed calculations, variance analysis,

[1] Michel Araten and Michael Jacobs, March 2001. LEQ means the same as EAD -- the exposure assumed to be outstanding at the time of default.

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and supervisory review would have to be repeated just to determine which report we would be eligible to submit. We would be less incented to pursue the advanced approach if this were the case. We strongly recommend the Committee eliminate the 90% floor. If the Committee retains a floor then it also should introduce a cap on how much greater the advanced approach could be compared to the foundation approach.

The second floor imposes a minimum probability of default (PD) of three basis points for the highest ratings categories. Banks should be allowed to use a lower probability of default estimate if they can provide the appropriate analytical support for doing so.

**3.5 Retail Assets**

Our analysis indicates that the calibration of the capital requirements for retail assets is far too onerous, particularly for credit card assets. The ratio of Tier 1 capital under the proposal (unexpected loss only) to our internal economic capital for credit card assets is over three to one. For all retail categories the ratio is a little over two to one. The Committee states that it is trying to calibrate capital for retail assets to be approximately half that for wholesale assets, whereas our internal relationship (which we do not try to fix) is considerably less than that. The proposed retail capital function includes the multiplier discussed above and incorporates correlations that are significantly higher than we observe. We recently made a presentation to the Committee's Models Task Force on our capital for retail exposures, which showed that the correlations we use for credit cards and other retail products are substantially lower than the correlations reflected in the Committee's formula. We do not consider the ratios of proposed required capital to internal capital to be consistent with a minimum regulatory standard. We strongly encourage the Committee to revisit the retail capital function in this light. In revisiting the approach to retail assets it would be helpful for the Committee to differentiate by product types insofar as possible to better reflect loss experience and correlations.

The question of whether regulatory capital requirements should cover both expected and unexpected losses or only unexpected losses is especially important in the context of retail portfolios. As we explained to the Models Task Force, our experience has shown that losses in retail portfolios tend to be less variable compared to corporate assets, even though the level of losses in certain portfolios such as credit cards can be higher. Banks have developed their pricing and reserving practices accordingly to address these characteristics. It would be penal to require banks to capitalize the expected losses in their retail portfolios without allowing them to include highly predictable income streams from the portfolios and any related reserves. As discussed above, a more appealing approach would be for the Committee to require banks to capitalize only unexpected losses in their portfolios, including in their retail portfolios.

**3.6 Small and Medium Enterprises**

Exposures to Small and Medium Enterprises (SMEs) do not fit precisely into either the corporate or the retail categories for capital purposes, primarily because they do not exhibit as low correlation as retail exposures nor do they exhibit as high correlation as corporate exposures. We believe the Committee could introduce an intermediate level for SMEs consistent with the Merton formula in the internal ratings approach by recalibrating the function with an assumed asset correlation of around 0.10. The definition of what constitutes a SME may vary slightly from bank to bank and should be reviewed as part of the supervisory process.

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**3.7 Credit Risk Mitigation**

As you know, the use of credit risk mitigation techniques such as credit derivatives and collateralization have increased significantly over the last several years. This has been a highly positive development, which has allowed firms to better align their business activities with their risk appetites. We strongly support the Committee's intention to promote the greater use of these techniques through improved treatment in the New Accord. We are concerned, however, that several aspects of the proposal would adversely affect the efficiency of credit derivatives market pricing and liquidity. Moreover, the proposed approach to collateralized transactions appears overly conservative in some areas, which could undermine the closer link between risk and capital the Committee is trying to achieve. The sections below discuss these issues in greater detail.

**3.7.1 Treatment of Credit Derivatives**

The combination of the W factor, the lack of recognition of joint default, and restrictions on the eligibility of protection providers results in a misalignment of risk and capital, thereby discouraging the use of credit derivatives. We strongly endorse the ISDA response on these matters.

**3.7.2 W Factor for Credit Derivatives**

We do not find that the Committee has clearly articulated the purpose of the W factor, especially for credit derivatives. As we understand it, W is meant to capture residual risks stemming from legal and documentation issues and to focus banks on the credit quality of the protection sellers. The W factor is not warranted on these grounds, particularly with the introduction of operational risk capital charges. We strongly recommend that the Committee eliminate the charge.

The enforceability of ISDA credit derivatives documentation has been demonstrated. Legal opinions support the enforceability of these contracts in a number of major jurisdictions. Numerous contracts have been triggered and successfully enforced since the beginning of the market in the mid 1990s, including in the most recent downturn. As of March 31, 2001, JP Morgan Chase alone has had 22 contracts involving 11 companies triggered. All counterparties, except for one, voluntarily performed in accordance with the contractual terms. The courts upheld the one contract that was challenged.

Other recent court decisions have upheld the enforceability of credit derivatives according to their underlying terms.[2] In addition, the recent Conseco case shows that sellers of protection perform even when they question the reasonableness of the outcome. As a result of this case, the members of ISDA have successfully collaborated on revisions to standard documentation that should alleviate the concerns of protection buyers and sellers going forward. Finally, current pricing indicates that the marketplace is comfortable with the legal standing of these instruments. If the Committee is concerned that banks could incur losses as a result of legal or documentation problems, then the operational risk in the capital requirements should be sufficient. To impose the W charge on top of the operational risk charge would be duplicative and distortive.

The W factor is not needed to focus banks' attention on the credit quality of the protection sellers. Banks are fully cognizant of the risk that sellers may not be willing or able to perform on their contracts. Accordingly, they apply a careful counterparty selection process as they do with any

[2] See e.g. URSA Minor Limited v. Aon Financial Products Inc.

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other financial contract. The Committee should not assume that credit analysis would be weaker in this area.

We are very concerned that the W factor will reduce efficiency in the credit derivatives markets. An increase in regulatory capital burden for protection buyers will undoubtedly increase the bid-offer spread. Moreover, we are concerned that the overall increase in capital friction will decrease liquidity. In particular, we are concerned that the asymmetrical treatment between credit derivatives and guarantees may cause banks to re-evaluate the current ISDA standards. Banks may be incented to pursue bank guarantees, which do not benefit from standard documentation, because they would not attract the W charge and therefore would incur lower regulatory capital requirements. As discussed in detail in an annex to the ISDA response, there is no legal basis for the unfavorable treatment applied to credit derivatives relative to guarantees.

**3.7.3 Joint Default**

The imposition of the W factor is even more troubling considering the fact that the New Accord would not recognize the benefits of joint default. Under the proposal, if a bank purchased credit protection it could only substitute the rating (and therefore the probability of default) of the protection seller[3] for the underlying. The bank could not reduce the probability of default to reflect the fact that two entities would have to default at the same time in order for the bank to incur a loss. This is an uneconomic result. For example, if we wish to reduce a large exposure to a given name with an AAA rating, we are better off if we hedge that risk in the credit derivatives market, even with a counterparty that is rated less than AAA. Economically, we would achieve greater risk reduction in our credit portfolio, but we would not be appropriately rewarded for doing so by the proposed capital rules. We believe that the recognition of the joint default benefit associated with credit derivatives is critical to creating appropriate incentives for banks seeking to hedge their risks. Such recognition would be consistent with market practice and would better align risk and capital.

In its comment on the June 1999 consultative document, ISDA suggested a relatively simple framework for discounting the substitution approach depending on whether protection providers and obligors had low, medium, or high correlation. We recognize the Committee might find an even simpler approach more appealing and that the criteria could, in some limited cases, yield results that were unintended. We are prepared to work with supervisors on further refining such an approach. An appropriate step in this direction might be to adopt the low/high correlation framework applicable to collateral under the proposal. Under this approach the exposure would be fully offset (after haircuts) if there were low correlation between the underlying and the collateral; the substitution approach would apply to a high correlation counterparty. For credit derivatives, supervisors could provide the definition for low and high correlation by identifying ranges of correlations which banks could then use to implement the approach. Banks would have to be able to demonstrate that relationships fell within the applicable correlation ranges. Banks that could not provide the necessary support could use the substitution approach.

**3.7.4 Eligible Providers**

We recommend modifying the eligibility criteria for credit protection providers. The requirement that corporate credit protection providers, including insurance companies, must be rated

[3] If the seller is a bank, sovereign, or publicly sponsored enterprise and its rating is lower than the underlying, or the seller is a corporate with rating of A or better.

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A or above is not justified. Insurance companies are important participants in the market for hedging credit risk, and we see no reason to discriminate against protection providers of equal credit standing. Corporate credit protection providers should be investment grade, or if they are sub-investment grade, banks should also obtain collateral eligible under the New Accord. Such an approach would be effectively symmetrical with the collateral recognition rules.

**3.7.5 Irrevocable and Unconditional Rules**

Although it was not likely the Committee's intention, a strict reading of paragraphs 123 and 124 of the proposal could lead to the conclusion that a credit derivative documented under an ISDA Master Agreement would not qualify for capital relief. A number of other credit events (including bankruptcy, default on indebtedness, and false representations) other than, as specified in paragraph 123, "the non payment of money due in respect of the credit protection contract" would allow a protection seller to "cancel the cover". Paragraph 124 prohibits a "clause...that could prevent the protection provider from being obliged to pay out in a timely manner." A technical violation of paragraph 124 could occur as a result of a clause in an ISDA Master Agreement allowing a non-defaulting party to suspend payment on all transactions under the agreement for so long as the other party is in default. For example, if Party A has failed to make a payment under an interest rate swap, Party B would be entitled to suspend payment under all transactions covered by the agreement (including a credit derivative under which Party B sold protection to Party A) until Party A cured the payment default under the interest rate swap. We recommend that the Committee clarify these rules so that documentation of credit derivatives under an ISDA Master Agreement does not disqualify them from capital relief in the New Accord.

**3.7.6 Restructuring**

We recommend that supervisors not require for regulatory capital purposes that restructuring be included in the list of credit events covered by a credit derivatives contract. Providing failure to pay protection only should be sufficient for recognition of credit derivatives in the New Accord. Restructuring should simply remain one of the several options that ISDA documentation users have at their disposal in tailoring credit protection to their needs. Nowhere else in the regulatory capital rules are banks required to capitalize upfront the possibility that they might restructure an asset. We do not believe it is reasonable to single out a particular contract type for such treatment. The ISDA response provides a more detailed rationale of the industry view on this issue.

**3.8 Collateralized Transactions**

**3.8.1 Repo and Securities Lending Transactions[4]**

As you know, repo and securities lending transactions play a critical role in promoting liquidity in global financial markets. Accordingly, appropriate regulatory capital treatment of these transactions is vital. We welcome the Committee's initiative to broaden the recognition of collateral in the New Accord. As explained below, however, we are concerned that some features of the proposal will work in the opposite direction. We have participated in the efforts of the Bond Market Association (BMA) and the Risk Management Association (RMA) on this topic and endorse their comments on the proposal.

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[4] Includes repos, reverses, securities borrowing and securities lending

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**3.8.2 Repo-Style Carve-Outs**

The Committee has proposed carving out government repo-style transaction (i.e. repos/reverses and securities borrowing/lending transactions) from collateral haircuts and the W factor, subject to certain conditions. We welcome this treatment because it reflects the very low credit risk associated with these transactions in light of past market experience and the way they are managed. As discussed in the BMA and RMA responses, these transactions are generally characterized by daily margining, daily marking to market of collateral, netting at the counterparty level where enforceable, rapid closeout and liquidation, and a strong legal foundation. Also, the vast majority of our counterparties are regulated financial companies that fit the carve-out description in paragraph 104 of the proposal. We assume these characteristics of the market have provided comfort to supervisors in establishing the carve-out for government repo-style transactions.

We recommend that the Committee extend the carve-out to other repo-style transactions that meet the criteria in paragraphs 102 and 104 of the proposal, subject to some modification. Specifically, those repo or securities lending transactions that involve eligible collateral under the proposal or collateral that would be eligible for a bank's trading account should quality for the carve-out. Daily marking to market of exposure and daily margining should be a requirement for the expanded carve-out. Any repo or securities lending transactions should be acceptable, provided they are subject to legally-enforceable agreements that incorporate the right upon the occurrence of well-defined events, including the event of default, to immediately close out the transactions and liquidate the collateral. Cross-border transactions that meet such a legal documentation standard should be accommodated.

**3.8.3 W Factor for Collateralized Transactions**

The W factor for collateralized transactions is not necessary and should be eliminated. If the W factor is meant to capture legal and documentation risk, we stress that these markets operate on a solid legal foundation. The BMA and the International Securities Market Association have promoted the use of standard documentation to promote legal certainty and liquidity. The lack of a legal component in the pricing of these transactions clearly indicates that the marketplace is comfortable with their legal standing. Even in recent events such as the Russian debt default, non-defaulting parties were able to exercise their legal right to liquidate collateral. The parties might have disagreed about valuations -- which the parties could dispute by legal means -- but there was no question about the legal entitlement to liquidate. The operational risk capital charge is intended to cover legal and documentation risk, so to impose a separate charge here would be an inappropriate double count.

If the W factor is meant to address the possibility that collateral could be difficult to liquidate in stress conditions, as the Committee's Capital Group has stated orally, we offer two responses. First, the Capital Accord generally does not address stress market conditions, except to require stress testing for more advanced techniques such as the internal models approach to market risk capital. Stress testing is largely a Pillar 2 issue. Second, firms will take the liquidity of an asset type into account in setting their own haircuts, but this process will be specific to the country and market involved. Accordingly, an across-the-board discount of 15% is not appropriate.

Finally, we observe that the W factor produces some anomalies. For example, a bank that is fully collateralized by cash, a riskless asset, would have to hold capital against the cash as a result of

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the W factor. Such an approach would be a drastic and inappropriate change from the treatment under the Current Accord.

**3.8.4 Haircut Correlations**

Even if the Committee does not broaden the carve-out in the final rule, it will be important for it to correct deficiencies in the proposed set of haircuts. Both the standardized approach and the foundation internal ratings approach require collateral to be discounted by additively applying haircuts to the exposure, the collateral, and any currency mismatch on a transaction-by- transaction basis. Such an approach is unduly conservative in that it assumes that the collateral, the exposure, and the currencies are perfectly correlated, which is unlikely to be the case. Subject to supervisory review and approval, the Committee should permit any bank qualifying for the internal ratings approach to set their own haircuts on a portfolio basis (by counterparty), including correlations between the underlying and the collateral. If the Committee were not inclined to go in that direction then imposing an independence assumption using the root sum of squares would seem more reasonable. Another alternative would be to impose the higher of the haircut on the exposure or the collateral rather than on both, which would factor volatility into account but not in an excessive manner.

In making these suggestions we note that the surcharge for foreign exchange risk presents particular problems from an implementation standpoint given that we apply a portfolio view to collateral. The proposal essentially requires us to look at each transaction to determine whether there is a currency mismatch. For our largest counterparties we may have thousands of transactions, which would make such an approach infeasible. For your information, what we do is agree with our counterparty on a schedule of eligible collateral assets and applicable haircuts. Eligible collateral can include US dollar cash and securities and certain non-US dollar cash and securities. Most non-US dollar collateral is in euros, yen, and pounds, where there is generally low volatility over the short period of the exposure. The counterparty can cover its collateral requirements for its net exposure by delivering any of the eligible assets. We do not separately try to identify a currency mismatch.

**3.8.5 Haircut Holding Period**

A ten-day holding period was used as the base case for calibrating the standard collateral haircuts and is imposed as a parameter for banks setting their own haircuts under the advanced internal ratings approach. In general, we believe any haircuts should reflect the period over which the bank is subject to the volatility of the exposure and the collateral it is holding. Given market practice and the strong legal underpinnings of repo and securities lending transactions, a ten-day holding period assumption is inappropriate. As explained in the RMA response, three days would be a more reasonable assumption for securities lending transactions given the daily margining process and the short time to liquidate collateral.

A similar observation applies to derivative transactions. Over the last year, some firms have evolved their practices such that the assumed time to closeout the transaction and liquidate collateral is around five or six days, not ten days. It would be inconsistent for the Committee to state on the one hand that it wishes to reward banks that demonstrate investment in strong risk management practices and then to impose capital requirements which do not acknowledge the investment. We urge the Committee to review this important parameter with a view towards setting haircuts on collateral that better reflect the risk.

**3.8.6 Confidence level**

We note that under the advanced approach banks are meant to use a 99% confidence level in setting their own collateral haircuts. While it is, of course, the prerogative of supervisors to set the prudential standard, you should be aware that we do not typically use such a high confidence level in setting our internal haircuts at this time. We use a 95% confidence level for derivatives collateral and 97.5% for securities lending. We urge the Committee to further consider market practice when reviewing this parameter.

**3.8.7 Market practice**

We wish to call your attention to a potential unintended consequence of a set of collateral haircuts imposed by regulation. There is some risk that the regulatory standard might become the basis on which certain market participants try to negotiate collateral arrangements. For example, in some cases banking organizations will want to impose more onerous haircuts than those in the proposal (e.g. for short-term sovereign debt) and would not like to see the regulatory practice used to inhibit its business practices or relationships. In this regard, it would be helpful for the Committee to emphasize that the regulatory haircuts in the standardized and foundation approaches are for purposes of satisfying minimum regulatory capital requirements and are not meant to substitute for sound market practice.

**3.8.8 Balance Sheet Double Count**

In considering modifications to the approach to collateralized transactions we also wish to call the Committee's attention to the fact that the proposed rules would result in a double count of risk for purposes of setting capital requirements for repos and securities lending transactions. Under the proposal, not only would a US bank have to hold capital reflecting haircuts and the W factor but it would also have to hold capital against an asset that is required to be on its balance sheet according to current accounting guidance. In a recent change in the accounting framework for securities-for-securities transactions, SFAS No. 140,[5] a security lender acting as principle that receives securities as collateral must record the securities received on its balance sheet. The lender continues to recognize the securities lent in its inventory. The result is that there are two assets recorded on the balance sheet instead of one.

Ultimately, banks can only experience a loss once when they have entered these types of transactions -- if a counterparty does not return the assets lent and the value of the assets that are held as collateral has declined below the value of the securities lent. Yet the proposed rules would require them to also hold capital for the potential loss due to holding assets on balance sheet. One way to avoid this double count would be to say that when engaging in a securities-for-securities transaction a bank only needs to hold capital against the difference between the market values of the two securities (after haircuts, including correlation effects). Under this alternative no additional capital would be required for the fact that assets might be held on balance sheet. We ask the Committee to review this double count issue when modifying the current proposal.

**3.8.9 Physical Collateral**

The Committee's proposal largely focuses on financial collateral. With the exception of gold and commercial and residential real estate, the proposal would not recognize other forms of physical

[5] Accounting for Transfers of Servicing of Financial Assets and Extinguishments of Liabilities

collateral. As many banks are active in various leasing markets and engage in other collateralized lending, we encourage the Committee to incorporate other forms of physical collateral into the final rules. Where banks can demonstrate the reasonableness of their valuation and, where applicable, haircut methodologies, we believe they should be able to offset exposure with appropriately adjusted physical collateral values. Recognizing that the Committee might benefit from additional industry input, we would be prepared to work with it on this issue over the next several months. We note that other industry associations, such as the International Air Transport Association, also are eager to work with the Committee on this matter.

**3.8.10 Legal Recognition of Collateral**

Paragraphs 92-95 of the proposal states that the holder of the collateral must have legal opinions from all "relevant" jurisdictions confirming the legal enforceability of its perfected security interest. We note that while market practice is to obtain a perfected security interest in collateral, banks do not always obtain confirming legal opinions. Accordingly, we hope the Committee can identify this is a strong practice for purposes of Pillar 2 but not require it in order to receive capital relief.

**3.9 On-Balance-Sheet Netting**

We recommend that the Committee allow banks to net on- and off-balance-sheet exposures, including repos and securities lending transactions, provided they have adequate legal support for doing so. The Committee has left open the possibility of netting in the past subject to appropriate documentation (e.g. the cross-product netting of off-balance-sheet exposures), and it would seem reasonable to do so here. We do not see the need to require loans and deposits with a single counterparty to be decomposed and netted on an individual basis, as proposed. A portfolio approach would be more appropriate on efficiency grounds. We also recommend that the Committee allow for cross-affiliate netting of transactions where the appropriately documented cross-guarantees are in place.

**3.10 Asset Securitization**

In light of our active role in securitization markets as an originator, sponsor, and investor, the regulatory capital treatment of these transactions is of critical importance to us. In the sections below we comment on key features of the proposal. We support the comments of the BMA, the Multi-Seller Conduit Group, and the FASB Issues Working Group on this part of the proposal.

**3.10.1 Minimum Requirements for Achieving a Clean Break**

The Committee has proposed minimum criteria that must be met before an originating bank can remove securitized assets from the calculation of the risk-based capital ratio. While we understand the Committee's motivation for setting these criteria, we are concerned that they extend beyond current requirements for sale accounting and non-consolidation, even in the United States. For example, the clean break requirements should not require a qualifying special purpose vehicle as defined in SFAS 140 because this is not the only way to achieve sale accounting or non-consolidation under US Generally Accepted Accounting Principles (GAAP). In addition, we think it is inappropriate to require a legal opinion for every transfer, which is not a requirement under US GAAP, although we acknowledge they will likely be obtained for complex securitization transactions.

Rather than trying to impose part of US GAAP or new requirements into the framework, we recommend that the Committee defer to local or international accounting standards that govern the transactions in order to avoid unduly complicating decision-making around structuring. In this way, compliance with local or international accounting standards also can provide a safe harbor for banks with respect to their regulatory capital requirements. For countries that may have less developed accounting standards, the Committee could undertake an information-sharing and educational effort, which supervisors could leverage at national discretion. In this regard, the requirements in paragraph 13 of the Asset Securitization annex can serve as useful examples of how a clean break can be achieved.

**3.10.2 Use of External and Internal ratings**

We support the Committee's reliance on external ratings in the determination of capital requirements for asset securitizations. As you know, the rating agencies play a significant role in the credit assessment process for all participants in this market. Once rated, tranches can be easily worked into either the standardized or internal ratings approach for calculating capital requirements. We encourage the Committee to utilize external ratings to the extent available for all parts of securitization structures, including first loss and second loss pieces, regardless of the role the bank is playing in the transaction (i.e. originator, sponsor, or investor). Accordingly, we recommend that the Committee drop the requirement that first loss or certain second loss credit enhancements[6] automatically be deducted from capital. Rating agencies will take into account levels of subordination in a structure when assessing the risk, which is more important than what a retained risk position technically is labeled.

The Committee has assigned higher risk weightings for a given rating category for asset securitizations than for comparably rated corporates. The Committee also has assigned a LGD assumption of 100% for securitizations in the foundation approach, whereas for corporates the assumption would be 50%. Recently available data from the rating agencies show that, if anything, overall risk in asset securitizations is considerably less than in corporate securities. For example, consider the following:

- Moody's shows no defaults in its historical database from 1985 to the present, regardless of rating
- S&P shows a single investment grade default, but it was the result of fraud.
- S&P shows some BB defaults but at a rate approximately half that of corporate BB exposures. S&P shows no defaults at the B level.
- Investment grade transactions show approximately one-third the downgrade risk of corporate transactions over a five-year timeframe, and subinvestment grade transactions show approximately 80% of the downgrade risk.

These data suggest that investment grade securitizations could reasonably attract one-third the regulatory capital applicable to corporates and that subinvestment grade tranches should certainly attract no higher capital than that applicable to corporates. We urge the Committee to reconsider its risk-weights and LGD assumptions in light of the highly positive experience in the asset securitization market.

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[6] Where first loss protection is not provided by a third party.

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Historical performance does not support a higher LGD assumption for asset securitizations than for corporates. In practice, when rating securitizations backed by collateralized debt obligations (CDOs), synthetic CDOs, or asset-backed securities (ABS) neither Moody's nor Standard & Poor's make 100% LGD assumptions, even in their stressed scenarios for rating such securitizations. In particular, the rating agencies make the following assumptions related to LGD for such underlying CDOs or ABS when rating these structures:

| Position rating | Moody's LGD assumption | S&P LGD assumption |
|---|---|---|
| Aaa/AAA | 15% to 55% | 20% |
| Aa/AA | 20% to 65% | 30% to 68% |
| A/A | 30% to 75% | 35% to 73% |
| Baa/BBB | 40% to 80% | 78% |
| Ba/BB | 50% to 90% | 88% |
| B/B | 60% to 95% | 93% |

These compare with Moody's and Standard & Poor's stressed LGD assumptions for corporate senior unsecured securities, which range between 58% to 85% (Moody's) and 50% to 70% (S&P). Given the comparability of the corporate and securitization LGD assumptions used in the stress scenarios applied by the rating agencies, we strongly encourage the Committee to reassess its view of a 100% LGD for securitizations and normalize the LGD number to be at least equivalent with similarly rated corporate exposures.

As the Committee has noted, not all securitization tranches are externally rated. In the absence of an external rating we believe it is critical that banks have a framework to assess regulatory capital that reflects the risk profile of the structure and does not default to the capital requirement applicable to the underlying obligations. The regulatory capital must reflect any credit enhancement.

In instances where no external rating is available, we believe the Committee should encourage banks to rate tranches through an internal process. Supervisors could review and approve each bank's process. If supervisors are not inclined to adopt such an approach, they could allow banks to generate ratings internally leveraging the rating agencies' models. So long as banks are able to input certain key factors that are typically developed as part of the structuring process but are not necessarily fixed model inputs,[7] we believe this could be a reasonable approach that would be manageable from an implementation standpoint.

Where a bank cannot generate a rating after considering the alternatives above, the proposed "look through"[8] approach is reasonable with some modification. The proposal would require assignment of the held securities to the risk weighting of the highest risk-weighted asset included in the underlying pool. We believe that the holding should be assigned to the risk-weighting of the weighted average rating of the underlying pool as this is a better reflection of the risk in that pool.[9] Banks that hold unrated retained or residual interests should be subject to the low-level recourse

[7] For example, discounts associated with maturity mismatches between the life of the vehicle and the life of the underlying pool.
[8] Where asset-backed securities are treated as indirect holdings of the underlying pool.
[9] The risk weights should reflect the benefit of any guarantees on the underlying collateral, including guarantees from sovereigns and banks.

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rules; they should hold the lesser of dollar for dollar capital for the amount of the retained interest[10] or the amount of capital required for the underlying pool.

The treatment of cash and synthetic asset securitizations would have to be adjusted for any decision the Committee takes regarding whether regulatory capital is meant to cover unexpected losses only or both unexpected and expected losses. To the extent the revised rules require dollar for dollar capital to be held for retained risks, banks should be able to adjust for allocated loan loss reserves. Consistent with the view expressed in Section 2.1 above, if the Committee intends for capital to cover both unexpected and expected losses, then loan loss reserves for expected losses should be included in the definition of capital without limit. We note that according to US GAAP residuals in cash securitizations are recognized on balance sheet net of expected losses.

**3.10.3 Treatment for Sponsoring Banks in Conduit Programs**

As discussed in pages 8-12 of the Asset Securitization Annex, we appreciate the difficulty sometimes involved in assessing whether commitment facilities provided by sponsors to conduit programs are for liquidity purposes only or provide credit protection to investors in the asset-backed paper. In this regard, the requirements in paragraph 54 to determine whether a facility is for liquidity purposes seem reasonable. We agree with the rationale in the BMA letter supporting why such facilities merit a low conversion factor. Facilities that are unconditionally cancelable, or that effectively provide for automatic cancellation without prior notice, due to deterioration of a borrower's creditworthiness, should continue to benefit from a zero credit conversion factor.

There is some ambiguity in the proposal as to whether such a facility would be multiplied by a risk weight in addition to the appropriate conversion factor. Our expectation is that it would be consistent with the rest of capital framework to do so, and we would appreciate the Committee clarifying this point. Assuming this is the case, we recommend that the Committee adopt the same framework suggested in Section 3.10.2 above to determine the appropriate risk weighting for the facility.

Where a commitment does not meet the definition of a liquidity facility under paragraph 54, and therefore is considered a credit enhancement, risk weighting according to the assigned rating (external or internally developed) is appropriate, provided, as recommended above, that the risk weightings for asset securitizations are modified. If there were no rating available, then it would be appropriate to risk weight the facility according to the weighted average rating of the underlying assets for which it is providing credit protection. The capital requirement, however, should never exceed the amount of protection the sponsor is contractually obligated to provide.

**3.10.4 Early Amortization**

The Committee has proposed applying a 10% conversion factor to the notional amount of securitizations with early amortization features. We understand the Committee's concern that such features could result in an originator absorbing a disproportionate share of credit losses. However, we do not believe an across-the-board conversion factor would be appropriate. Rather, the specifics of the transaction should be taken into account. Where the seller's interest does become subordinate according to the payment allocation formula such a conversion factor would seem reasonable.

[10] Plus any gain on sale.

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Where this is not the case, the conversion factor would be unreasonable. Banks should be able to make this determination on a case-by-case basis, subject to supervisory review.

As part of the justification for the conversion factor, the Committee cited concerns about sudden liquidity and capital needs should there be an early amortization. In this regard, we note that nowhere else does the Current Accord require capitalization for funding, and it would be inequitable to do so for these types of transactions. Moreover, banks must continuously adjust their capital positions in light of changes in their portfolio composition, so it would be inappropriate to charge capital upfront for the potential that the bank might extend new credit as a result of early amortization features.

**3.10.5 Synthetic Securitizations**

We also support relying on external ratings and internally developed ratings to the maximum extent possible for synthetic securitizations. Our rationale and recommended approach are the same here as for traditional asset securitizations, regardless of whether the bank involved is an originator, sponsor, or investor.

For the standardized approach applicable to originating banks, we recommend that the Committee adopt the treatment incorporated in the Federal Reserve's SR 99-32[11] with some modification. The SR letter provides reasonable capital treatment for when a bank invests in credit-linked notes, retains the first loss piece of a synthetic asset securitzation, retains the senior risk position, or retains both (including whether the senior risk is hedged or unhedged). An important modification for the Committee to make in both the standardized approach and any internal ratings approach, however, is to eliminate the condition that first loss pieces must be no greater than expected losses. There is no such restriction for traditional asset securitizations. Moreover, there is no economic justification for it given that first loss pieces will be considered (a) capital deductions when determining the appropriate amount of capital for positions in synthetic securitizations or (b) to have capital assessed against them pursuant to their rating. We also think there should be flexibility around what proportion of the portfolio should be transferred into the market as opposed to the 10% minimum suggested in paragraph 83 of the Asset Securitization Annex.

In general, we support having minimum operational requirements for obtaining preferential capital charges. However, some of the criteria in paragraph 86 of the Asset Securitization Annex appear to be unnecessary or unrealistic. For example, no early amortization or other contingent credit clauses would be permitted. Rather than impose a ban on such features, we believe they should be dealt with on a case-by-case basis as they would be by the rating agencies. There also is a suggestion that notes or securities will have to be rated by two agencies. While this might be feasible in some instances, it might not always be the case. Accordingly, we suggest the Committee drop this criterion.

**3.10.6 Implicit Recourse**

We find the measures related to implicit recourse listed in paragraph 90 of the Asset Securitization Annex to be unduly harsh. Instead, we recommend that implicit recourse be handled on a case-by-case basis, guided by the general rule that actions that generate retention of risk will trigger recourse treatment of affected transactions. In addressing implicit recourse on a case-by-case

[11] Capital Treatment for Synthetic Collateralized Loan Obligations, November 17, 1999.

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basis, it would be highly beneficial for supervisors to document their decisions and supporting analyses. If proprietary information can be properly protected, it also would be helpful if the decisions and rationale could be made publicly available in a manner similar to current US staff interpretations.

**3.10.7 Disclosure Requirements**

We understand the motivation for the Committee to specify certain disclosure requirements in order to obtain preferential capital treatment where market practices or disclosure standards might be underdeveloped. Where local market practices and accounting standards are well-developed we believe the Committee should defer to them.

**3.11 Equity Investments**

The Committee has requested comment on two possible methods for calculating regulatory capital for equity investments. The two methods suggested were a market risk framework based on stress testing and a credit risk framework based on PDs and LGDs. We agree with the basic philosophy behind the two frameworks that capital should be tied to the risks of the particular investments. The risk for equity investments is long-term and can be quantified based on historical data. A credit risk framework is not appropriate, however, because financial and historical data generally do not exist for individual investments that would be suitable for a risk-rating approach. A market risk framework would be more viable because long-term data exist for general market movements. The available data are particularly amenable to an approach based on stress testing.

However, as the Committee is no doubt aware from the various bank presentations to the Models Task Force on this topic, market practices for allocating internal economic capital to equity investments vary considerably. As a result, we believe it would be difficult to develop a market risk regulatory capital framework for equity investments at this time. Although the Committee successfully implemented a VAR approach through the Market Risk Amendment, there was more commonality in banks' methodologies for trading risk than appears to be the case today for equity investments.

We would like to discuss with the Committee the issues around developing in the near term a market risk framework for equity investments. In the meantime, we suggest the Committee consider adopting as an interim measure an approach similar to what the Federal Reserve Board recently proposed, whereby the amount of regulatory capital would adjust on a sliding scale depending on the size of equity investments relative to capital. We provided some technical comments on that proposal but have no objection to the overall approach at this time. Consistent with the view expressed in Section 2.3 above, we recommend that in any final rule the Committee not require the simple summation of capital for equity investments with the capital for other risk types because we observe meaningful diversification with the other risks.

**3.12 Project Finance**

We recognize that project finance is an area that may require further work by the Committee in cooperation with the industry. In general, for exposures where the recourse is to the cash flows and available collateral from the project itself, and not to the obligor, the internal ratings framework of PD, LGD, and EAD can still be applied. We believe banks should be able to incorporate such projects into their internal ratings capital calculation if they can demonstrate the adequacy of their

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approach to the supervisors. We would be pleased to discuss this issue in greater detail with the Committee.

### 3.13 Banking Book and Trading Book Distinction

We welcome the broadening of the trading book eligibility criteria. This will encourage banks to further the development of a disciplined marking to market process for credit assets. We believe that banks whose income statements, balance sheets, and economic capital reflect changing market risk factors and asset quality can more easily develop a strong discipline in the management and measurement of credit risk. Such banks have strong incentives to address credit problems at a very early stage. Some banks already manage portions of their portfolio in this manner, particularly their derivative receivables. Accordingly, in addition to broadening the trading book eligibility criteria, the Committee should not require banks that dynamically manage their derivative receivables or other credit assets this way to hold banking book capital charges, as is required under the Current Accord. Only market risk capital charges should apply.

We note that some of the requirements for receiving trading book treatment would thwart the incentives noted above. In particular, the requirement that loans be "free of any restrictive covenant on their tradability or ability to be hedged completely" is too onerous (paragraph 567). Virtually all loan agreements require that both the borrower and the agent consent to any assignment, although such consent cannot be unreasonably withheld. In addition, loan agreements typically have minimum amounts that can be assigned. We recommend that the eligibility standards for trading book treatment reflect market practices in the loan market.

The calculation of the specific risk capital charges for positions hedged by credit derivatives warrants some modification. For example, the requirement that there be an "exact match in terms of reference asset, maturity, and currency to the underlying exposure" (paragraph 584) does not reflect either the current practices or documentation in the credit derivative market. Most traded credit derivatives have a definition of obligation, which is typically all senior unsecured borrowed money, and have as a deliverable obligation all senior unsecured bonds and loans. Full offset -- rather than the proposed 80% offset -- should be permitted for traded credit derivatives, provided that the asset hedged falls within these broad definitions. Moreover, full offset should be permitted if the maturity of the credit derivative exceeds the maturity of the reference asset.

### 3.14 Counterparty Credit Risk

We understand that the Committee has been exploring enhancements to the current approach to calculating capital for counterparty credit risk. We strongly recommend that the Committee allow banks to calculate their exposures for counterparty credit risk based on their internal models, subject to supervisory review and approval. Such exposure amounts would then be risk-weighted consistent with the weights or formulas applicable to other credit assets. The calculation of exposure should be based on the concept of expected positive exposure as described in the related appendix in the ISDA response. For firms that do not use their internal models, we envisage that the existing method would remain in place with some modification. That is, counterparty credit exposure would be calculated as the positive mark-to-market values plus add-on for possible future market movements. Importantly, the add-on calculation should be a function of the net risk positions not the notional amounts, as is the case today.

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**3.15 Comparison to the Standardized Approach**

It is an improvement over the current rules to base capital requirements on external ratings as proposed in the standardized approach. However, we feel there are a few features of the standardized approach which warrant modification to achieve the appropriate incentives and risk sensitivity in the New Accord. We make the following suggestions recognizing that it is difficult to strike the right balance between simplicity and accuracy in such a framework.

As we pointed out in Section 1, the capital required for sub-investment grade corporate assets is considerably less under the standardized approach than under the internal ratings approach. Under the standardized approach, the highest amount of capital required for sub-investment grade assets is 12% compared to a range of approximately 15% to 50% for similarly rated assets under the internal ratings approach. We have already discussed why the internal ratings risk weights are too onerous. By setting the required capital at such drastically different levels the Committee is creating disincentives for banks to use the more advanced techniques available under the New Accord, which are much more sensitive to the risk inherent in low-grade assets.

In addition, the Committee has introduced a risk-weighting scheme in the standardized approach that leverages ratings but then appears to abandon the benefits of the ratings process through the risk weights themselves. The primary example is that banks could receive a favorable risk weighting compared to corporates with identical ratings. Such treatment would perpetuate an anomaly in the Current Accord. We recommend the Committee review the standardized approach with a view towards promoting consistent and equitable treatment insofar as possible for assets with similar risks as evidenced by their ratings.

Also, the two risk weight options for banks are confusing, particularly as they relate to the risk weights for sovereigns. For internal purposes we treat banks and corporates as 100% correlated to the sovereign for cross-border exposures. We cap their ratings at the sovereign rating. For local exposures we allow corporates to be rated higher than the sovereign, consistent with the findings of our internal research and historical experience. We think a simpler approach for the Committee to take would be to have a single set of risk weights applicable to banks and corporates, subject to the sovereign ceiling. We would make an exception to the sovereign ceiling, however, for local corporate exposures.

**4. Operational Risk Capital Requirements**

We welcome the Committee's initiative to include specific measures governing operational risk in the scope of the proposed New Accord. This initiative has mobilized the industry to action, has instigated a significant effort to develop improved risk measurement techniques and identify industry best practices, and has facilitated a debate which will serve to enhance the quality of operational risk management overall. We are equally encouraged by the open and constructive approach the Committee's working groups have engendered throughout this process. Continuing such a dialogue will be critically important over the coming years as the industry and the regulatory community work collectively to refine our understanding of operational risk and to establish an appropriate regulatory framework for this risk category.

Our comments on the proposal relating to operational risk are organized into two sections. The first section highlights the key principles we believe should govern the rules and capital requirements for operational risk. Any material divergence from these principles will undermine the

integrity and applicability of the New Accord as it relates to operational risk. The second section provides a number of topic-specific comments on selected aspects of the proposal. In light of the issues below, we strongly recommend that the Committee consult again with the industry on specific proposals related to operational risk prior to developing final rules.

### 4.1 Key Principles Guiding Operational Risk Capital Rules

Below are the key principles that we believe should guide the requirements and provisions of the capital rules governing operational risk.

#### 4.1.1 Risk-Based

By far, the most important principle governing the New Accord is that it must be risk based. The methodology and metrics used to calibrate risk should reflect actual risk levels. As data improves and methodologies are developed to more accurately measure operational risk the New Accord should embrace these enhancements. Capital requirements governing operational risk should not be subject to arbitrary computations such as multipliers or add-ons; there should be no minimums or other adjustments that will result in an inappropriate divergence of regulatory capital requirements from actual risk levels. To the extent regulatory capital rules avoid these shortcomings and are risk-based, this approach will converge with economic capital practices, thereby reinforcing improved risk management in an efficient and effective manner.

#### 4.1.2 Transparent

As discussed in Section 1, the methodologies developed and employed by regulators to calculate and govern operational risk capital should be transparent to the institutions governed. Capital requirements and related rules should be calibrated and promulgated within Pillar 1 under clearly understood rules and guidelines. Pillar 2 should not be routinely used by regulatory authorities to arbitrarily adjust or override Pillar 1 requirements; capital charges or adjustments levied under Pillar 2 should be limited to unusual circumstances.

#### 4.1.3 Scalable

The rules and requirements of the new capital framework must scale appropriately to the size and sophistication levels of a wide range of financial institutions. In general, we support the spectrum approach as it is now proposed because it is very consistent with this principle. As described below, other features such as calibration techniques, qualifying criteria, and linearity issues also need to be considered in a manner consistent with this principle. However, we do not support a spectrum approach that omits specific provisions for a fourth option (loss distribution approach) that could be utilized when sufficient data exist and other capabilities are appropriately demonstrated.

#### 4.1.4 Flexible

The regulatory process governing operational risk must be flexible in order to embrace the rapidly developing techniques for operational risk measurement, and the significant improvements in data quality and availability that are anticipated in the coming years. Without such flexibility the regulatory and capital framework established now will soon become outmoded by these changes. The process for incorporating these advancements into regulatory practices in a timely and effective manner should be outlined within the New Accord.

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**4.1.5 Fair**

To the extent possible, implementation of capital requirements and related regulatory practices should be consistently applied across regulatory jurisdictions. We suggest that clear guidelines for regulatory authorities be established to encourage consistent implementation of the rules and fair treatment of financial institutions across regulatory jurisdictions.

**4.2 Specific Comments on Selected Features**

**4.2.1 Delineating Risk Categories**

It is critical to establish and maintain clarity and integrity on the definitions of and delineation between operational risk, market risk, and credit risk. Practices vary between institutions, but historically many banks have co-mingled operational risk losses in their credit and market risk data. Indeed, frequently an operational error manifests itself as a credit or market loss. Co-mingling these risks hinders accurate risk measurement, often blurs accountability, and generally is an obstacle to good risk management practices. We recognize that historical data sets are valuable risk measurement tools and their usefulness must be safeguarded. Nonetheless, we support an approach in the new capital framework that:

- establishes clear and accurate distinctions between risk classes
- defines industry standards for data capture and risk reporting
- adjusts for any double-counting of risks which may result
- provides a foundation for clear risk measurement and accountability
- leads to improved risk management practices within our industry.

**4.2.2 Complexity of Risk Measurement**

A variety of proposals regarding the calibration of operational risk have been discussed amongst industry and regulatory working groups. Notwithstanding our general support for the spectrum approach, we believe certain proposals contain unnecessarily complex and ill-advised computations proposed in the interest of increased precision of measurement. At this stage of development in the science of operational risk measurement, we strongly suggest that formulas remain straightforward and rudimentary rather than complex and burdensome. Once sufficient data become available and methodologies are tested and proven beneficial, more complex measurements can be finalized and implemented. Specifically, the use of numerous exposure indicators and the risk profile indices in the internal measurement approach appear overly complex techniques whose usefulness has not been tested.

**4.2.3 Linearity**

Notwithstanding the preference expressed above for a straightforward calibration of operational risk capital at this time, we strongly believe that some adjustment should be made that acknowledges that operational risk is not linear. Various industry studies and working papers have documented this fact. Simply stated, as business volumes double risk does not. Any capital requirement that does not incorporate an adjustment for this non-linearity will result in distortions in the capital charged to larger institutions. We support by reference the comments submitted by ISDA and the Institute of International Finance on this subject.

**4.2.4 Spectrum Approach: Reduced Capital and Qualifying Criteria**

As indicated earlier, we strongly support a scalable framework for operational risk capital that accommodates a wide range of institutions in terms of their size, business complexity, and sophistication of the risk management environment. We support the principle of a relative reduction

of required capital for institutions as they progress through the spectrum approach, provided they maintain increasingly sophisticated and robust control environments. Indeed, we support the establishment of specific and rigorous qualifying standards that institutions must meet before progressing to the next level in the spectrum approach. Also, as indicated above, the framework established must include a direct reference to a loss distribution approach (option 4) and specifically outline the regulatory process that institutions must meet to qualify for this final option.

**4.2.5 Qualitative Adjustments**

There should be qualitative adjustments to the quantitative calibration of operational risk. Such qualitative adjustments as these:

- may be necessary and appropriate to override or adjust for data outliers or gaps
- should reflect actual changes in organizational structure or control environment
- would provide a forward-looking risk focus overlay on static, historical data
- would provide appropriate incentives for continuous improvement in risk management.

Qualitative adjustments could be both positive and negative. They should be based on a pre-established and disciplined methodology and consistently applied. Regulatory review of this methodology would be required to qualify for this approach. Also, such adjustments should only be available if they are also incorporated in an institution's economic capital framework.

**4.2.6 Loss Data Sharing**

We are strongly supportive of industry initiatives to establish a forum for sharing selected information on operational losses and related data. Without such data pools, detailed analysis and modeling of operational risk will be difficult. Benchmarking performance across the industry will not be possible. Risk and capital measurement tools will develop more slowly, if at all. In short, properly structured and utilized industry loss data can greatly enhance operational risk management practices within our industry. Concerns regarding confidentiality, among other things, can be sufficiently mitigated with proper safeguards, standards, and security.

**4.2.7 Risk Mitigation/Risk Transfer**

To the extent an institution could properly demonstrate that operational risk has been legitimately transferred through insurance, third-party service agreements or other techniques, we strongly believe such risk transfer should be reflected in a deduction from both economic and regulatory capital requirements. More work needs to be done to ensure that the full range of techniques results in real risk transfer. Nonetheless, the new regulatory capital framework should accommodate such developments.

**4.2.8 Regulatory Reporting Requirements**

We fully appreciate that the New Accord will require some incremental level of regulatory reporting. To the extent the regulatory capital approach is truly risk-based, information requirements should be closely aligned with data required for economic capital purposes. Under these circumstances providing such data for regulatory purposes would be completely reasonable. Loss data and certain business metrics are legitimate examples of this.

However, should the regulatory approach diverge from the risk-based principle, a framework could develop that requires significant information whose sole purpose is the calculation of regulatory capital. We are strongly opposed to any regulatory capital framework that requires a

significant accumulation and reporting of information if such information is not readily available through the normal course of business. For example, we are strongly opposed to any extensive standardized questionnaires that would be used to score control environments with a view that these would be used to calibrate or adjust operational risk capital for regulatory purposes.

**5. Pillar 2 -- Supervisory Review Process**

We believe it is desirable to shift the emphasis in the capital framework to the Supervisory Pillar as discussed in the consultative proposal. Some supervisors attempt to do this today, and the proposal should help level the playing field internationally. A strong supervisory pillar also is needed to support the view that capital requirements should represent minimum standards and that determination of a well-capitalized firm should be based on a supervisory assessment.

We have no objection to the principles for supervision outlined in the proposal. We do believe, however, that they will have to be implemented flexibly to reflect specific factual situations for individual institutions and local market issues. Also, we think it is important that national supervisors be familiar with best practices in the area of bank supervision and take whatever steps are necessary to obtain the appropriate authority and resources to move in the direction of those practices. In this regard, we stand ready to work with supervisors in the United States and internationally to assist in education and training initiatives as we have done for some time. With respect to the suggestion that supervisors could increase capital requirements to reflect greater risk, it is worth noting that (1) some banks' internal credit models essentially function this way and (2) such increases should only be considered in the context of safety and soundness concerns. Supervisors should not second guess banks' internal capital optimization decisions.

**6. Pillar 3 -- Market Discipline**

As a general matter, we continue to support the Committee's view that capital requirements and market discipline are important complements. We are troubled, however, by the direction the Committee has chosen with respect to Pillar 3. In order to utilize the proposed risk-sensitive approach to regulatory capital that avoids the severe problems associated with the existing regime, a bank must adhere to a new set of extremely detailed disclosure requirements. We strongly recommend that the Committee eliminate this linkage. In creating the new requirements we believe the Committee has not clearly articulated how they would enhance market discipline. The Committee's requirements would introduce adverse competitive issues for banks. Moreover, the proposal is inconsistent with recent recommendations by other relevant groups, including one on which the Committee is, in fact, a member.

**6.1 Unclear Benefits**

US banking organizations already disclose most of the capital, market risk, and credit risk data that form the basis of many of the core disclosure requirements in the proposal. Yet there appears to be a presumption with respect to the newly proposed disclosures, particularly those in Section III of the Pillar 3 Annex on the internal ratings approach, that more risk-oriented information will inherently improve market discipline. We do not believe this is necessarily the case for the following reasons:

First, in order for the public disclosure mechanism to work users must be able to understand and act on the information. As publicly available information grows in scope and complexity, it becomes harder for even the most sophisticated users to digest the origins and meaning of the data. In this

regard, the snapshot nature of disclosure practices makes it virtually impossible for users to have an up-to-date picture of a bank's risk profile given how dynamically portfolios can change.

Second, to the extent readers of financial statements are interested in downside risk, no set of disclosures can realistically explain how an individual firm will be affected by the next market disruption, nor will disclosures necessarily be relevant to the next market disruption. It is difficult even for managers themselves to anticipate such effects, and firms are legitimately concerned about disclosing proprietary or market-sensitive information through data that can be extremely difficult to interpret.

Third, market discipline does not depend solely on public disclosure. Rating agencies, for example, act effectively as agents of public creditors but with privileged access to virtually any information they request. Accordingly, they have the ability to assess complex and/or sensitive information that would be beyond the reach of most users of public disclosures.

Fourth, so long as major financial institutions remain subject to prudential supervision, the markets will rightly presume that supervisors have superior information and the right to use it for rehabilitation or intervention purposes.

Moreover, many of the proposed disclosures, particularly in Section III, would not even meet the materiality test established by the Committee in paragraph 20. Under that test information would be considered material if its "omission or misstatement could change or influence the assessment or decision of a user…" Using that definition it is hard for us to see, for example, why it would be critical to disclose "…summary statistics of distribution of (actual) LGD, such as standard deviation and $10^{th}$, $50^{th}$ and $90^{th}$ percentile at default at 1, 2, and 3 year intervals and weighted with exposure". We question whether readers of a bank's financial statements would actually have to rely on this information to assess the bank's credit risk management and measurement skills in light of other relevant, readily available information.

**6.2 Competitive Issues**

The new disclosures proposed by the Committee, in particular those related to internal ratings and operational risk, go far beyond the current requirements in jurisdictions with the most developed accounting and disclosure standards. As a result, banking organizations would be forced to disclose information that key competitors that incur similar risks would not be required to disclose. This is unreasonable for at least two reasons. First, the new disclosures will impose a significant burden on banks. The Committee states that there should be little incremental cost to making these disclosures because banks already collect the information for internal purposes. The Committee is mistaken on this point. It is an enormous undertaking to produce audit-quality financial statements, and it would be a significant challenge to ensure that the new credit and operational risk data would be adequately captured, controlled, understood in the context of our overall performance, and communicated through our public reports.

Second, if the Committee believes that the new disclosures are essential to inform readers of financial statements and to enhance market discipline, then it should work with securities commissions and accounting bodies worldwide to develop a consultative process for recommendations that would apply to all firms incurring similar risks. We note that the Committee's efforts appear to have been undertaken without close coordination with other standard

setters such as the International Accounting Standards Commission, the Financial Accounting Standards Board, and the Joint Working Group of standard setters. We note that the ISDA response discusses specific areas where the Committee's requirements either duplicate or contradicts guidance from those bodies.

**6.3 Recent Recommendations on Disclosure**

The Committee's new disclosure requirements would be inconsistent with the recent reports by the Working Group on Public Disclosure (Shipley Group) and the Multidisciplinary Working Group on Enhanced Disclosure (Fisher Group), the latter of which the Committee is a member. After carefully reviewing industry practices and a range of potential enhancements to public disclosures, both groups adopted a set of principles to guide an evolutionary approach to future risk management disclosure practices. Both groups made a set of incremental recommendations consistent with those principles. In contrast, the Committee's proposals for new disclosures are extreme in terms of detail and complexity and cannot be considered evolutionary.

**6.4 A Way Forward**

In light of the above, we strongly recommend that the Committee reorient its approach to Pillar 3 as follows:

- Building on work the Committee has already done in this area, it should compile an inventory of existing strong capital and risk management disclosure practices by banks and other financial firms. National supervisors should then address whether their banks are disclosing in a manner consistent with the strong practices and whether their local accounting and disclosure standards support such practices. To the extent supervisors identify gaps, they should then take the appropriate action in cooperation with local standard setters.
- The Committee should support the recommendations by the Shipley and Fisher groups and promote an evolutionary approach to future disclosure practices.
- If it wished, the Committee could transform the detailed list of disclosure requirements and recommendations in the current proposal into a single set of recommendations or guidance. Such a document might be helpful to banking organizations and other financial firms when thinking about their disclosures going forward.
- The Committee should seek to engage national and international standard setting bodies to ensure that the disclosure requirements for banks and other firms develop in a fully integrated fashion.
- Finally, because supervisors, rating agencies, and some private creditors play critical roles in the discipline of global financial institutions, there should be continued reliance on the furnishing of certain complex and sensitive risk information through those channels rather than through public disclosure.

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**7. Leverage Ratio**

The leverage ratio is no longer an appropriate way to measure banks' capital adequacy because it is not adequately related to risk. We understand that the US Federal banking agencies have wanted to keep such a measure in place in light of the limitations inherent in the Current Accord. With the introduction of significantly more risk sensitive credit risk capital rules and the operational risk capital component of the New Accord, the agencies' concerns should be addressed. Accordingly, in conjunction with the implementation of the New Accord in the United States, we strongly recommend that the agencies eliminate the leverage ratio for US banking organizations at both the holding company and bank levels.

In closing, we wish to express our desire to work with the Committee on all aspects of the proposal. Should you have any questions about this response, please do not hesitate to contact Adam Gilbert, at 212 648-3504, or me.

Very truly yours,

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## Appendix 1: Risk Diversification Simulation Study

Last year, our Risk Methodology Research group conducted a simulation of the firm's primary risk factors, including market risk, credit risk, operational risk, and equity investments. The study was not specifically aimed at evaluating the diversification benefit across business areas. However, some of the results are useful in drawing broad conclusions about diversification. Note that all results refer to heritage JP Morgan only, and do not include heritage Chase.

### Operational risk

Operating risk creates a very large diversification benefit because it has a very low correlation with the economic variables that drive returns for market risk, credit risk and equity investments. This was based on a statistical study conducted by JP Morgan's Operational Risk Task Force and PricewaterhouseCoopers. On a diversified basis, operational risk contributed 75% less to the firm's overall loss at the 99.8% downside confidence interval due to the diversification benefit.

The low correlation between operating risk and business cycles can be seen in the current environment. Stock markets and credit markets are down dramatically in the last year. However, there is no evidence that operating risk losses are increasing.

This shows the importance of managing operating risk through insurance, rather than capital. It is inefficient from a macroeconomic perspective for banks to maintain capital to self-insure operating risk. It is much more efficient to insure these risks because of the low correlation. The Committee should encourage this through recognition of insurance as a way to offset capital requirements for operating risk.

### Credit risk

There was a much lower diversification benefit for credit risk in our firmwide simulation. On a stand-alone basis, the diversification benefit was in the area of 20% at the 99.8% downside confidence interval. This is large enough to justify a regulatory benefit, but it is clearly less material than the diversification benefit for operating risk. The benefit would be smaller for firms with large credit portfolios and relatively small market risk. For them, credit capital represents the bulk of their capital, and there would be little overall diversification benefit.

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**Market risk**

The diversification benefit for market risk depends on the positions involved as described in the following table:

| Primary market risk positions | Correlation with credit portfolio |
|---|---|
| Long equity delta<br>Short equity implied vols<br>Long corporate bond credit spreads<br>Sell credit protection via CDS<br>Receive fixed interest rates in emerging markets<br>Long FX in emerging market currencies | These risk positions would be positively correlated with credit losses in most cases. Both normal and stress correlations suggest that these markets move together, driven by investor risk tolerance.<br><br>Opposite positions would have a negative correlation with the credit portfolio. As an example, Equity Derivatives generated a negative incremental impact on economic capital due to the long positions in equity implied vols. |
| Receive fixed interest rates in developed markets | Given extreme market moves, these positions would be negatively correlated with credit losses in most cases. Since 1950, there has been positive expected return on the long T-bond (up 2.1% during the month) during periods where the S&P 500 declined by more than 10% in the month. There are a few scenarios (e.g., flight from the dollar) where a positive correlation might occur. |
| Long FX in developed markets | These positions would have essentially zero correlation with credit losses. There is no "up" or "down" with these positions. They represent an exchange of value. |

Based on JP Morgan's positions during November 2000, there was a substantial diversification benefit, reflecting the fact that market risk losses were not highly correlated with losses in the credit portfolio.

Following the merger of JP Morgan and Chase Manhattan, we conducted another study of the diversification benefit across internal capital categories. Using two different methodologies -- one similar to a stress test and the other based on external market proxies -- we confirmed that there is a significant diversification benefit across our internal capital categories.

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## Appendix 2: ISDA Comments on Entry Requirements for the Internal Ratings Approach[12]

Consolidated supervision

para 159 -- It is essential that regulators co-operate amongst themselves to minimize the costs of potentially contradictory capital and validation requirements. This is a particular issue for financial groups operating cross-borders. If in some jurisdictions, the internal ratings based (IRB) approach was unavailable, and then it would not be appropriate to apply the principle that no capital relief can be granted for intra-group transactions where some business units are treated under IRB and others under the standardised approach. Groups involved in mergers may be faced with a similar situation, where segments of the group use the IRB approach, while others do not, or at least not yet.

Rating grade structure

para 240 -- The Committee should be somewhat less specific in establishing minimum requirements for rating grades. We think the Committee should ensure through the supervisory process that the distinction between investment grades and non-investment grades sufficiently reflects the bank's risk profile. The IRB function itself provides a natural incentive for banks to develop a granular approach to rating their exposures.

para 242 -- The Committee should eliminate the requirement that no more than 30% of gross exposures can be in any one risk grade. This should be addressed in Pillar 2, where 30% could be used as guidance. An implication of the requirement, as drafted, is that banks should lower their underwriting standards if they have a concentration of assets in a high quality risk grade. The composition of the portfolio should be left to management discretion.

Coverage of ratings

para 244 -- Instead of the requirement that each borrower must be assigned a rating before any loan is originated, banks should be required to have policies around ratings coverage and the treatment of unrated exposures. It might not be functionally possible to assign a rating in all cases before a borrowing takes place (e.g. certain overdraft facilities).

Assignment of ratings

para 246 -- The requirement that reviews or re-ratings are conducted at least annually should be guidance. Banks should have the flexibility to have a less frequent review for certain credits, e.g. where there is low risk or where new information is not yet available.

para 247 -- The Committee should eliminate the requirements to act within 90 days of receiving new information about a borrower or within 30 days for a weaker credit. When to act on information should be left to management discretion and discussed as part of the supervisory process as appropriate.

Oversight by the Board of Directors

para 248 -- The requirement that the board approve all material aspects of the rating and probability of default (PD) estimation process (also LGDs and EADs as specified in later paragraphs) is

[12] Some differences might appear as a result of editing. Specific paragraph references are to the annex titled the New Basel Capital Accord.

intrusive and out of step with the role boards typically perform. The approval process for the ratings system should be left to management discretion.

para 249 -- We have a similar view on reporting requirements to the board. The frequency and type of reporting should be left to the discretion of the relevant senior managers, risk managers, and business managers. The level and the change in the amount of economic capital consumed by the credit business may be far more useful to the board as a summary measure than the list in the proposal.

Internal and external audit
para 253 -- Requirement for annual review of ratings system by Audit should be made more flexible. Again, guidance is preferable to a requirement. Similar view on review of PD estimates in paragraph 275.

Risk assessment
paras 262-263 -- There is some contradiction between the required one-year horizon (point-in-time approach) and the statements in para 262 that reference a "through the cycle" approach. (See also para 270 where there is a contradiction between the first and second sentences.) We suggest that the Committee expect banks to estimate one-year PDs after considering available material information that reflects the financial condition of the borrower and the bank's assessment of the borrower's ability to perform according to contractual terms.

para 265 – It should not be required that transfer risk be considered in the borrower rating, as this contradicts the principle of a separation between borrower risk and facility risk.

para 283 -- It is reasonable to require a five-year historical observation period for PD estimates for corporate assets. At the same time, we believe banks should retain flexibility to weight observations to reflect their prevailing credit view or changes in the portfolio. Moreover, to help preserve a level playing field, banks should not be required to use longer observation periods if the data are available.

For retail assets, five years will be too long, as most scoring systems are re-calibrated every two to three years. Consumer credit scorecards provided by external vendors are usually replaced every three to four years in order to reflect changing market conditions and consumer behavior. We would suggest that a two-year observation period is more appropriate. Moreover, due to the almost continuous improvement of retail scorecards, it would be unreasonable to expect that the entire portfolio should be re-scored. The use of samples rather than the entire portfolio should sensibly be accommodated.

para 285 -- Grandfathering or transition guidelines are likely to be required for the data collection and storage requirements in this paragraph. These are particularly onerous, and for some, bear little relation with internal ratings validation. We would suggest streamlining the list, in order to make it more effective, or to include it as guidance.

Use of internal ratings
para 291 -- Default probabilities used for capital purposes may not be the same as those used for pricing purposes given different views of the relevant time horizon and the methodology used to

derive the default probabilities for specific instruments. For example, some banks use the term structure of "risk-neutral" default probabilities for corporate assets pricing purposes and not the one-year PD

para 292 -- The requirement that setting of limits and lending authority must be linked to ratings should be guidance. It is reasonable to base certain limits or authorities, for example, on notionals or economic capital calculations.

para 295 -- Banks do not necessarily mark all of their portfolios to market or to model for profitability reporting purposes. The requirement to tie PDs to general profitability analysis should be guidance only.

paras 297-298 -- If the portfolio is largely unchanged in terms of overall risk assessment, it may not be necessary to stress the entire portfolio every six months. Stresses targeted at certain classes of exposures or portfolios are likely to be more valuable in this context.

Internal validation

paras 302-305 -- Despite our general concerns about being able to truly validate credit models, annual testing of model outputs against actual outcomes does not seem unreasonable. The key issue will be how validation gets addressed through the supervisory process. Supervisors must be willing to accept reasonable results as opposed to certainty.

para 313 -- The definition of eligible commercial real estate excludes project lending etc. Physical collateral has value and should be recognized at some level in the revised Accord. More work is required to determine appropriate haircuts.

Minimum requirements for the advanced IRB approach

para 342 -- LGD and EAD estimates must be based on seven years of data, in contrast to PD estimates which can be based on five years. LGDs and EADs should also be based on a five-year observation period.

para 361 -- LGD stresses are meant to be conducted every six months and should address, among other things, "the correlation in estimates of PD and LGD across exposures." We do not understand why banks are required to stress test correlations in this context where they cannot provide correlation estimates for the purposes of calculating Pillar 1 capital requirements in the first plâce.

para 388 -- It does not make sense to set limits for EADs; the requirement should be removed.

para 392 -- EAD link to general profitability analysis should be removed from Pillar 1.

para 394 -- EAD observation period should be consistent with PD and LGD. (See comment on para 342.)

Reference definition of default

paras 272 and 466 -- ISDA supports the reference definition of default adopted by the Committee for corporate assets. We would note that total consistency is not necessary between the IRB

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definition of default and the list of credit events covered under guarantees/credit derivatives contracts.

Of the four events described in the Committee's reference definition of default, only some may be relevant for certain types of exposures. For example, default for corporate exposures is defined at obligor level, but for retail exposures it is in fact analysed at transaction level[13]. Other examples include the following: OTC derivatives exposures are not restructured, the 90 days past due rule is not applicable to overdrafts and other retail products,[14] and banks' defaults are characterized by distinct events (removal of authorisation, provision of liquidity support by the central bank). Banks should be allowed to flexibly interpret the reference definition of default to reflect the nature of their exposures, as well as the manner in which these exposures are managed.

The main purpose of the reference definition of default in our view is to guide banks in their data collection process, by identifying which events should be tracked, thereby ensuring that they build sound and reasonably consistent databases from which PD and LGD data may be derived.

Segmentation of retail exposures

paras 443-447 -- The division of exposures into homogeneous segments is an important part of the risk management of retail assets. Each segment should be as homogenous as possible with respect to the credit characteristics of the assets within it. However, each segment must also contain a sufficient number of assets to allow statistical estimation of default probability, severity, and exposure at default. There is a tension between achieving homogeneity, which would naturally tend to increase the number of segments, and having statistical significance, which would tend to restrict the number of segments. Getting the right balance between these two is extremely important.

The suggested segmentation in the Committee's consultation paper may not be appropriate for all portfolios. The most ideal segmentation is likely to differ between products, jurisdictions, and even between banks within the same jurisdiction. The key test is that the characteristics chosen by the bank should be those used internally to manage the business. Each institution should be free to choose the segmentation it deems most appropriate, and specific segments should not be made compulsory. The institution should justify its chosen scheme (on the basis of performance) in the supervisory review process.

A key point is that, whilst a bank should be free to choose its own segmentation, it must be capable of mapping each of these segments to a PD, LGD, and an EAD. This mapping will ensure that capital levels are consistent over time, across products, across jurisdictions, and across individual banks.

Not allowing an institution to choose its own segmentation could lead to a number of problems:

- The most appropriate variable to distinguish borrower quality may well change over time. For example, an application score may be appropriate for the initial few months, after which a behavioral score may be a better estimate of default probability.
- New products are being developed continuously. It is important that the proposals are able to accommodate such market developments.

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[13] Experience has shown that an individual might default on his credit card payments but never on his mortgage.

[14] Nor is it fully applicable where the counterparty is simply late in meeting its obligation.

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- The "tension" described above implies that a bank should optimize its choice of segments by using those which are most discriminating. However, if compulsory segments are set which are less discriminating, then banks will either have to use a sub-optimal segmentation, or have unduly small populations in some parts of the overall segmentation.
- Assets that do not have the requisite attributes may lead to those assets being unfairly penalized. For example, assets originated prior to the introduction of scorecards may be unscored. However, because they are "old" assets they are likely to have performed for an extended period, and therefore be of very high quality. A more flexible segmentation scheme would allow for these assets, where it can be established (e.g. from delinquency rates) that they are of higher quality, to be treated favorably.

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