May 31, 2001

The Bank for International Settlements
Basel Committee on Banking Supervision
Centralbahnplatz.2
4002 Basel
Switzerland

Re: A New Capital Adequacy Framework: Second Consultative Paper issued by the Basel Committee on Banking Supervision (January 2001, the "Proposal")

Ladies and Gentlemen:

MBNA America Bank, N.A. , having two additional banking subsidiaries, MBNA Europe Bank Limited and MBNA Canada Bank (together "MBNA") welcomes the opportunity to provide comments with respect to the second consultative package on the new Basel Capital Accord issued in January 2001 (the "Proposal"). MBNA America Bank, N.A. is the principal subsidiary of MBNA Corporation and focuses primarily on retail lending. In fact, MBNA is the largest independent credit card issuer in the world. At December 31, 2000, MBNA Corporation reported assets net of securitizations totaling $38.7 billion.

MBNA acknowledges the efforts of the Basel Committee on Banking Supervision (the "Committee") to develop a more sophisticated approach to capital allocation. However, MBNA is deeply concerned that the value derived from the Proposal's theoretical approach will not justify the expenditures in time, money and people necessary for its eventual implementation. The Committee proposes the elimination of a capital adequacy framework that creates a "level playing field" for the banking industry, is marked by its relative simplicity, is clearly understood, is easy to administer, provides useful numerical measures and functions exceptionally well.

As a replacement for the current capital adequacy guidelines, the Committee proposes guidelines that are voluminous, complicated, at times ambiguous and in many cases not yet developed. This change will create a significant burden on national supervisors, financial institutions, investors, rating agencies and other affected constituencies. While the Proposal may be of a greater conceptual purity, it will ultimately produce a less useful standard for measuring the capital-related financial strength of an institution. To be direct, MBNA does not believe the value created by the Proposal will approach the resources expended for implementation. We strongly suggest the Committee not proceed with the Proposal in this form.

MBNA does not believe the Proposal is justifiable from a cost/benefit perspective. We also recognize that the Committee may not reach the same conclusion. Therefore, despite our strong opposition to the Proposal, we believe it is necessary to provide more specific comments.

- **We believe many provisions of the Proposal reflect either uncertainty or a lower priority with respect to retail lending. For retail lenders, the Proposal will almost certainly produce higher regulatory capital requirements with no obvious higher systemic risks. Given the 100% risk weighting for retail loans under the standardized approach to credit risk combined with additional regulatory capital requirements for operational risk and asset securitization, it is a near certainty that regulatory capital requirements will increase substantially. It is inconceivable to us that such uncertainty can be the basis for additional capital requirements. Regardless of the quality of a banks retail loan portfolio, controls, method of approving credit, track record, earnings and conservative lending strategy, the Proposal does not adequately measure risk in the retail lending business. Given the higher regulatory capital requirements for retail lending, some banks may pursue greater risk, as the Proposal does not provide capital incentives for a conservative, well-managed financial institution.**

- **The "redistribution" of capital requirements among financial institutions that is likely to occur as a result of the Proposal, will not in our view enhance competitive equality, but instead will create a competitive advantage to a select few very large banks without any demonstrable positive effect upon safety and soundness.**

- **The Proposal will create a competitive disadvantage for the banking industry, as certain non-bank entities will not bear the burden of increased regulatory requirements.**

- **The cost of implementation for the Proposal, even under the most basic approaches, will be significant. Implementation of the more advanced approaches will be available only to very large banks. The Proposal will represent a significant regulatory burden for most banks. Additional staff, systems and audit resources will be required to implement this effort. These resources will entail significant cost and overhead, which will be disproportionately felt by smaller institutions.**

- **MBNA is especially concerned with completely new areas of assessment such as capital requirements for operational risk. We do not believe such capital requirements are measurable with anything approaching the desired level of precision. The Proposal should eliminate the provisions related to operational risk capital requirement. MBNA recommends that operational risk continue to be addressed on a case by case basis under the Pillar II.**

- **The Committee's time frame for implementation is extremely aggressive, especially the goal of a final proposal by year-end 2001. The Committee will receive new and significant input from many interested parties as a result of the January 2001 version of the Proposal that will not have been considered by other respondents. In addition, the December deadline for publication of a new set of final rules is far too hasty. This arbitrary deadline limits both 1) the industry's ability to provide thoughtful comments and 2) the Committee's ability to adequately evaluate those comments. Given that the Committee is proposing a**

complex, far-reaching change to the capital adequacy rules that will have a long-term impact, it is absolutely critical that members of the industry have the opportunity to review and respond to subsequent changes to the Proposal. We feel that the December deadline should be set aside for at least one year to allow additional time for further analysis and input from industry participants.

MBNA respectfully requests the Committee's consideration of the following comments in the development of a new exposure draft.

I. Credit Risk – The Standardized Approach

A. Claims on Banks

The Proposal will employ one of two options to assess risk weights for banks. National supervisors will choose one of the two methods and their choice will apply to all banks in their jurisdiction. The first option will be to weight each bank one category below that assigned to its sovereign of incorporation. The second option will utilize the ratings assigned directly to the individual bank by external credit rating agencies, and will allow for assessment at one category more favorable for claims with an original maturity of three months or less.

MBNA strongly supports the first option as it aligns the bank's risk weighting with the sovereign's rating and avoids the capital penalty imposed on unrated banks. The use of the sovereign rating as the benchmark for each bank incorporates the sovereign's overall financial strength, and reflects the overall strength of the banking sector. This strength derives from the ongoing examinations by sovereign regulatory agencies that review and monitor the safety and soundness of each institution. The first option is also closer to the current risk weightings for OECD and non-OECD country incorporations, respectively. The second option provides too much power to external rating agencies, allowing them to have significant say in determining a bank's required level of capital, even without regulatory agreement. In addition, as discussed below, the second option will add significant additional steps to the process of computing risk-based assets.

MBNA seeks clarification on the interaction between the first option noted above and the rules for issuer vs. issue-specific assessments. Paragraph 54 of The New Basel Capital Accord Consultative Document states that where an issue-specific assessment is available, the risk weighting will be based on that assessment rather than on the issuer rating. Under the first option for determining risk weights for exposures to banks (other than short-term inter-bank claims), will an investor still have to look for an issue-specific rating for a bank-issued debt?

B. Multiple Assessments

The guidance of the Proposal is ambiguous with respect to the use of external credit assessment institutions (ECAIs). It appears that the Proposal intends to require banks to first identify one or more qualified ECAIs which it will utilize for identifying asset ratings, and then to refer only to those selected ECAIs as the source of ratings for any given issue. It could be interpreted, however, that the Proposal requires banks to consider the assessments of all qualified ECAIs for each issue or

issuer. If this is the case, the use of ECAIs and the rules governing multiple assessments will impose an impractical burden and cost on banks. We request the Committee to clarify this point.

In order for a bank to determine the lesser of the two best assessments, which they will be required to do if more than two assessments exist, the bank will first have to determine if multiple assessments exist. For each issue or issuer, every qualified ECAI used by the bank will have to be checked to see if a rating has been issued by that institution. Then the bank must gather all of the assessments in order to identify the two best. This requires a substantial amount of data gathering, continuous tracking of that data and monitoring of ECAIs. If the Proposal does in fact require all qualified ECAIs to be reviewed, banks will need to monitor every one in order to determine: 1) if any newly added assessments have been made, 2) if any claims have been upgraded or downgraded, 3) if any ECAIs have been newly qualified for recognition by the national supervisor, 4) if the national supervisor has discontinued recognizing any ECAIs, and 5) which ECAIs have only limited eligibility and for which types of claims they are eligible to issue ratings.

A number of specific points require clarification in the Proposal concerning the use of ECAIs. Specifically, we request further guidance on the following issues:

- How and when banks declare which ECAI(s) they intend to use (assuming banks have this discretion)
- The minimum and maximum number of ECAIs which can or must be utilized
- How often banks will be allowed to change their chosen ECAI(s)
- At what point an upgraded or downgraded rating must be recognized in the computation of risk-weighted assets (e.g. if a change is made by an ECAI after the report date but prior to the submission date for regulatory reporting)
- At what point a change in an ECAI's qualification status must be recognized

We request the Committee clarify these points.

C. Higher Risk Categories

The Proposal calls for 90 day past due accounts to be weighted 150% to reflect the increased risk inherent with delinquent accounts. Specific provisions can be netted against the past due balances prior to applying the 150% weight. Banks with retail loan portfolios will not be able to take advantage of the "specific provisions" exception, due to the nature of their receivables and allowance methodology. However, MBNA strongly believes that the Committee needs to maintain consistency in determining capital requirements. The proposal would more heavily weight loan balances on past due accounts but give no capital relief to balances on accounts that are current, which would still carry a 100% risk weighting. This will further increase capital requirements, as the average risk weighting for retail loans would be greater than 100%.

In general, the standardized approach recognizes that assets possess different characteristics that make them more or less risky than other assets. Accordingly, the standardized approach allows for a variety of risk weightings to reflect these relative differences among assets (e.g. corporate issues rated AAA would carry a 20% risk weight, issues rated BBB would carry a 100% risk weight and issues rated below BB- would carry a 150% risk weight).

If balances on past due accounts are viewed as more risky and are accordingly weighted at 150%, balances on accounts that are current should be recognized as carrying a less-than-average level of risk; however, this is not the case under the standardized approach. Therefore, a more balanced regulatory capital approach should be available to recognize that, just as balances on past due accounts can be predictive of eventual write-offs, balances on accounts that are current are indicative of a greater-than-average likelihood of full and current collection of the balance due.

II. Credit Risk - Internal Ratings Based Approach ("IRB")

MBNA understands the Committee's goal of modifying capital requirements to better reflect the relative risks associated among various assets. In particular, an Internal Ratings Based ("IRB") approach allows banks to achieve a greater understanding of their exposure to credit risk and enhance their ability to manage that risk. MBNA has serious concerns regarding the imposition of a mandatory system that relies solely upon the standardized approach to credit risk with no IRB alternative. However, significant work remains in the development of an IRB for retail loans. It is important that the appropriate amount of time is invested to develop an IRB for retail loans that creates capital incentives for lower risk loans.

An IRB approach can take advantage of the substantial and ongoing advances in the ability of certain banks to measure and analyze the credit risks of various activities. If an IRB approach is adopted, it should be structured to be an administratively efficient form of regulation that builds on processes banks have in place for various risk management purposes.

MBNA has specific comments and requests clarification in the following areas.

A. Definition of Default

While MBNA supports the Committee's attempt to provide a consistent definition of default, we believe that the definition of default implemented by the U.S. Federal Financial Institutions Examination Council ("FFIEC") on February 10, 1999 is better suited for retail exposures. The FFIEC definition of default is the result a significant effort by both banks and regulatory agencies. MBNA would strongly encourage the Committee to review the existing FFIEC policy and adopt its approach. This would more likely lead to consistent interpretations among national supervisors and would be easier for retail lenders to apply. The FFIEC default definition is as follows:

1) The obligor is past due more than 180 days on any open-end credit obligation;
2) The obligor is past due more than 120 days on any closed-end credit obligation;
3) Unsecured retail loans to obligors where the bank has received notification of filing from a bankruptcy court is considered in default within 60 days of receipt or within the past due time frames, whichever is shorter;
4) If the loan is fraudulent, within 90 days of discovery, or within the past due time frames, whichever is shorter; or
5) In cases where the obligor dies, loans would be considered in default when the bank determines the amount of loss or within the past due time frames, whichever is less.

We also recommend that the Committee not expressly limit the types of loss forecasting methodologies available to institutions under an IRB approach, particularly with respect to retail

loans. There are a number of empirically derived methodologies used to forecast credit losses in retail loan portfolios, including score based models and delinquency roll rate analysis. The reliability of these methodologies is very effective and can be validated by retail lenders.

B. Unfunded Loan Commitments

MBNA questions the Committee's difference in treatment of unfunded loan commitments between the standardized approach and the IRB approach. Under the standardized approach, commitments with maturities less than 1 year would have a 20% conversion factor while commitments in excess of 1 year would have a 50% conversion factor. These conversion factors are in contrast to the IRB approach factor of 75%, regardless of maturity. MBNA supports a consistent methodology to commitment conversion factors, regardless of the approach and would support the use of the standardized methodology within the IRB approach. MBNA does not consider it appropriate for banks to be penalized with increased capital requirements on commitments for using the IRB approach**.**

C. Collateral

MBNA supports the wider recognition of collateral (from government securities and cash) and the use of on balance sheet netting and guarantee agreements as increased use of credit mitigation techniques can only reduce bank exposure to credit risk and improve risk management practices. However, in the United States, other sources of collateral (i.e. aircraft, machinery, accounts receivable and inventory) play a significant part in credit risk mitigation. The Committee should consider allowing the discretion of national supervisors to widen the definition of collateral as a useful supervisory tool. Appropriate collateral can be defined as part of the supervisory review process discussed in Pillar 2.

D. Historical Observation Period/Transition

We strongly support the Committee's proposal to relax certain requirements during a transition period. A requirement for a minimum of a 5-year historical observation period would effectively prevent MBNA and other banks from implementing an IRB approach for retail exposures concurrent with the targeted 2004 effective date for the Proposal. Without a transition period for compliance, MBNA would be required to use the standardized approach for a minimum of 2 years beyond the 2004 target. We urge the Committee to propose a lengthy transition period. The needed transition period will be much longer than 2 years considering the time needed to develop the appropriate segmentation analysis, confirm that it is acceptable to the national supervisor and complete the necessary system modifications. Also, we assume the transitional arrangements will allow a bank to adopt an IRB approach at the outset of the Proposal.

III. Asset Securitization

MBNA is actively involved as an originator of asset securitization transactions and would be directly impacted by the Proposal. Since 1986, MBNA has securitized over $95 billion of credit card and other consumer loans through more than 145 separate transactions. These transactions have been structured with loans originated in the United States, United Kingdom and Canada. During this 15-year period, MBNA has never experienced any loss with respect to its securitization transactions.

MBNA has also played an integral role in developing innovative securitization structures and providing guidance to the Financial Accounting Standards Board on securitization matters. We believe our extensive depth of securitization experience uniquely positions us to address the Committee's securitization questions and concerns.

MBNA believes that asset securitization provides strong risk diversification and enhanced financial stability for banks. MBNA also understands the Committee's desire for promoting consistency between capital requirements and the economic risks of securitization. The asset-backed securitization market is generally a rated market. Credit ratings by ECAIs are widely employed and relied upon by market participants as indicators of the expected credit performance of asset-backed securities. MBNA generally supports the Committee's proposal to utilize external credit risk ratings to assess the capital risks related to securitizations as more fully described in the standardized approach to asset securitization. With certain critical exceptions noted below, MBNA considers the Committee's approach to be an improvement over the current methodology. However, we do not in any way, support the application of capital penalties based on the product type (securitization vs. corporate debt) and type of participation (investor vs. originator). Additionally, MBNA supports a system that includes an IRB alternative as opposed to one that relies solely on external credit ratings.

A. Standardized Approach – Treatment for Originating Banks

1. Clean Break

The Committee has proposed certain minimum requirements to achieve the "clean break" necessary for an originating bank to remove the assets from its balance sheet for purposes of calculating risk based capital ratios. In many ways, the proposed requirements appear to be consistent with the requirements included in Statement of Financial Accounting Standards No. 140 (FAS 140), recently adopted in the United States. Throughout the implementation process for FAS 140, many complex legal issues necessary to address the legal isolation/"beyond the reach" test were evaluated and resolved. Therefore, MBNA does not believe it is necessary to impose any additional supervisory clean break requirements, particularly in jurisdictions that have well-defined accounting and legal standards.

If the Committee retains the currently proposed language, we would like the Committee to consider the following technical comments:

- Do not include the "true sale" requirement specified in paragraph 518 of the Proposal. A better test would be to rely on the legal isolation requirement specified in paragraph 518(a). The term "true sale" has a very specific legal meaning in the United States and is not appropriate in all circumstances.
- Do not require that each transferee be a qualifying special purpose entity as indicated in paragraph 518(b). MBNA recommends that the language in paragraph 518(b) be amended to conform to the language in paragraph 9(b) of FAS 140.
- Confirm that absent any special national legal considerations, there will not be any additional operational requirements to achieve "clean break".

2. Credit Enhancement

MBNA agrees with the Committee's position that originating banks providing credit enhancement should hold capital related to the enhancement position. However, MBNA strongly believes there should be limitations on the amount of capital required for originating banks providing credit enhancement and not all credit enhancement should result in a dollar for dollar capital requirement. The current language does not appear to be consistent with these objectives.

- First, the process of securitizing a group of loans generally does not create additional credit risk. Therefore, the aggregate amount of capital requirements associated with a securitization transaction should not be greater than the amount of capital required for those loans had they not been securitized. MBNA suggests the Committee adopt the low level recourse rules currently used in the U.S.
- Second, securitization transactions often include multiple layers of "credit enhancement" or protection to more senior investors that take a variety of forms, including subordinate tranches and spread accounts. Credit enhancement is sometimes sold to third parties and other times retained by the seller. Any form of credit enhancement should be evaluated in a manner consistent with other credit risks and not based on who holds the risk. Thus, MBNA recommends that the Committee eliminate the portion of paragraph 16 in the Asset Securitization Supporting Document that requires prior loss protection to be provided by a third party. Additionally, MBNA believes the capital requirements identified in paragraph 26 of the Asset Securitization Supporting Document serve as a meaningful benchmark for credit enhancement capital requirements. Finally, it is more appropriate that additional risk, if any, be addressed by the national supervisors and not directly specified as part of the Proposal.

3. Servicer Liquidity Advances

MBNA supports the concept that loan servicers be permitted to advance cash under certain limited circumstances to provide short-term liquidity to a securitization. We also agree that reimbursement of the advance should be from subsequent collections with the benefit of available credit enhancement. However, we would like to note that certain securitization structures repay liquidity advances prior to any payments to investors, others do not. Therefore, the Committee should remove the requirement that payment to <u>any</u> investors must be subordinated to reimbursement of the "liquidity" advance. MBNA recommends that capital requirements for any liquidity advance should instead be based on the level of credit risk associated with that particular advance. For example, if the liquidity advance was repaid on an equal basis with a "AAA" rated senior tranche, the risk weighting for that liquidity advance should be 20%. This treatment would be consistent with the Committee's objective to determine capital requirements based on the level of credit risk.

4. Capital Requirements for Securitizations with Early Amortization Features

MBNA is completely opposed to any proposal that would broadly require banks to hold capital (with a minimum 10% conversion factor) against assets securitized in transactions that include early amortization features. This effectively applies a penalty to all financial institutions that securitize. A better approach would be to apply corrective measures to issuers that do not properly manage their

securitization programs. This type of determination can only be effectively addressed as part of the supervisory review process in Pillar 2.

MBNA firmly believes that financial organizations that have incorporated sophisticated internal credit, liquidity and interest rate risk management strategies to evaluate and protect against the risks related to securitized assets should not be penalized with increased capital requirements. MBNA encourages the Committee to include language to emphasize that securitization risks should be evaluated on an “institution by institution” basis as part of Pillar II and that significant weight should be given to the overall internal risk management practices of that organization. In this situation, the national supervisor would be responsible for making such determination. MBNA firmly believes this approach would be consistent with the Committee’s recommendation to encourage the use of prudent internal risk management strategies by organizations that are best qualified to evaluate those risks.

If the Committee insists on requiring capital for assets securitized in transactions with early amortization features, then there should be an acceptable transition period. At a minimum, any new capital requirement should be implemented on a prospective basis and not apply to existing securitizations.

B. Standardized Approach - Treatment for Investing Banks

MBNA agrees with the Committee’s proposal to rely on credit ratings from ECAIs to assess capital against the risks arising from securitization transactions. This approach is consistent with the Standardized Approach for assessing credit risk. However, the Committee should maintain that consistency by harmonizing the risk weights between claims on corporate securities and securitization tranches. A securitization tranche rated BB+ should not require a 150% risk weight while a corporate security with the same rating only requires a risk weighting of 100%. This difference in risk weightings is not justified given the favorable default and downgrade performance of securitizations.

Certain securitization structures issue short term securities and therefore only require a short term rating. MBNA utilizes such a structure. The current version of the Proposal does not contemplate such short-term issuance structures. MBNA recommends including short-term ratings in the capital risk assessment. This is consistent with the Committee’s overall approach and should be included in the risk-weighting matrix.

MBNA does not support the committee’s view imposing additional eligibility requirements for an ECAI in the area of securitization. In order to qualify as an ECAI, a ratings organization will demonstrate the ability to assess risk appropriately. This should qualify them to assess the risks associated with securitizations. It is unnecessary and burdensome to single out securitizations and require additional hurdles for an ECAI.

The Committee proposes a “look through approach” for unrated senior securities in a securitization. This would permit the investor to “look through” to the risk of the underlying assets. MBNA would encourage the Committee to also consider other methods for investors to achieve a more realistic capital assessment for unrated securities. For example, if an unrated securitization relies on the performance of the same pool of assets as a rated securitization, and the structure of the transaction

is materially the same as other rated transactions, then the investor should be able to reference the rating on those related securities. Specific examples of this situation are credit card master trust securitizations, which rely on one large pool of loans, with multiple "series" issued to investors. In addition, the market has evolved into the issuance of homogenous structures, which should facilitate comparisons between rated and unrated securities. We strongly believe this additional flexibility should be part of the standardized approach.

C. The Standardized Approach – Treatment for Sponsoring Banks in Conduit Programs

MBNA does not currently provide liquidity to or sponsor any conduit programs. However, as part of a diversified funding strategy, we do sell assets to conduit programs sponsored by other banks. Therefore, the Committee's proposal with respect to conduit program sponsors will have a direct impact on our overall funding program. As a result, MBNA has actively participated in the development of and supports the two Multi-Seller Conduit comment letters.

D. Securitization Under IRB: A Hybrid Approach

MBNA supports the development of an IRB approach for securitization that offers a tangible incentive in the form of lower capital requirements for securitization structures. We would like to see the securitization IRB approach developed in conjunction with the overall IRB proposal. Additionally, MBNA reinforces its objection to dollar for dollar capital reductions for first loss credit enhancement. Any IRB approach should be based on the risk of the credit enhancement and not assume dollar for dollar capital reduction is appropriate. The Committee should be consistent in its application of capital requirements based on credit risk and not demonstrate a bias against a specific product type (i.e. securitization).

E. Implicit and Residual Risks

MBNA understands the Committee's concern that originators of securitization transactions may be subject to moral or reputational risk related to those transactions. We believe that with minor modifications, the approach specified in paragraph 90 of the Asset Securitization Supporting Document represents an appropriate regulatory response for this particular issue. Banks that knowingly violate the recourse rules should be held accountable for their actions on a case by case basis. However, MBNA is aware of only a few isolated examples of banks that violated the recourse rules and strongly opposes any capital charge broadly applied to certain securitization structures in anticipation of banks taking actions to support their securitization transactions.

MBNA believes the mandatory disclosure requirements included in subsection c of paragraph 90 are unnecessary. Disclosure requirements such as this are better addressed on a case by case basis through Pillar 2.

MBNA strongly opposes any *ex ante* minimum capital charge related to implicit and residual risks for securitizations as discussed in paragraph 91 of the Asset Securitization Supporting Document. The securitization process allows the credit risk associated with a pool of loans to be allocated among a variety of different parties, enhancing liquidity within the banking system. To arbitrarily assess a capital charge to originators of all securitization transaction for implicit/residual risk, completely disregards the risk transfer process inherent in securitization structures and assumes that

all financial institutions will behave inappropriately, based on the actions of a few "outlying" institutions. In addition, the underlying logic is flawed. If for example, Bank A originates and securitizes a pool of good quality loans that requires a lower amount of credit enhancement compared to a securitization by Bank B, the Committee is suggesting that Bank A would have a greater amount of implicit/residual risk. If anything, Bank A is in a more favorable position than Bank B. This type of potential regulation creates a dangerous situation for both banks and the securitization market, and is unwarranted given the overwhelmingly favorable performance of the market and its participants. This implicit/residual risk clearly should be addressed in Pillar II, Supervisory Review, allowing poorly managed securitization programs to be identified and dealt with on a case by case basis.

IV. Operational Risk

MBNA has significant concerns with the proposal to allocate capital for operational risk. In particular, the basic indicator approach to credit risk focuses on gross income as a single indicator. This basic indicator approach is fundamentally flawed in that an efficient, well managed and controlled bank with high earnings would compute a higher operational risk capital requirement than a lower earning and potentially poorly managed bank. This creates an outcome that is inconsistent with the Committee's goals in that profitable, well managed banks will be penalized compared to less profitable banks.

The more advanced approaches to operational risk are not sufficiently developed and need considerable refinement prior to implementation. Incorporation of operational risk generally into the capital adequacy assessment process is in the very formative stages. There are virtually no workable, widely available risk models, and the empirical data to support this methodology is sorely lacking. In fact, similar to treatment of interest rate risk, measurement of operational risk would be better suited to Pillar II without any mechanically derived capital requirements being assessed to the banks. This would allow bank examiners to review internal controls, audit reports, management experience, etc. in order to identify and deal with institutions that demonstrate a higher risk exposure. This would be preferable to a model that broadly applies an operational risk capital charge.

There are several areas of the Operational Risk component of the Proposal with which MBNA has significant concern:

A. Definition of Operational Risk

The proposed definition of operational risk includes direct and indirect losses. Based on the difficulty of quantifying the indirect cost of operational losses, the definition should only include direct operational losses. Additionally, the operational capital charge should be limited to those risks that can be quantified objectively with a fair level of confidence. No consensus has yet been reached on which operational risks can be quantified for regulatory policy purposes. We also firmly believe that a clear distinction needs to be made between losses arising from credit risk and trading risk and other related operational losses.

B. Expected vs. Unexpected Losses

The Proposal specifies the calibration of the operational risk capital charge be based on expected and unexpected losses, allowing some recognition for provisioning and loss deduction. For banks such as MBNA, which is primarily retail in nature, expected operational losses could be reasonably covered through reserves, provisions, and/or product pricing. Including expected losses in the calibration of the operational risk capital charge we believe will either overstate the level of necessary operational risk capital or require institutions to modify the way they plan for expected operational losses. Although there have been instances in the banking industry where operational losses have caused significant financial losses, MBNA would support a flexible regulatory approach where the risk profile of an institution would determine the inclusion of expected and unexpected losses in operational risk capital calibration.

C. Proposed Operational Risk Capital Charge

Although the Committee suggests that operational risk accounts for 20% of current minimum regulatory capital, MBNA would note that: 1) very few institutions perform these calculations; 2) there is substantial variability around the average; and 3) loss data statistics that are publicly available are insufficient to derive a meaningful industry-wide figure for benchmarking purposes.

According to our calculations, the level of operational capital increases from the Basic Indicator to the Standardized Approach, contrary to the expectation of the evolutionary approach. Much additional work is needed to ensure that this portion of the Proposal is equitable to banks with varying risk profiles. More specifically, an increased level of detail is needed relative to the Business Lines and Indicators for retail operations.

For the Basic Indicator and Standardized Approaches, there is little consideration of an institution's control environment. The existing U.S. regulatory framework considers the quantity of inherent risk, the quality of risk management, and the overall direction of the institution's risk profile. MBNA recommends a refinement of the existing regulatory framework to incorporate a qualitative assessment of the operational risk control environment to adjust the amount of operational risk capital. A strong qualitative risk assessment should serve to mitigate the level of capital that otherwise would be required. Regulatory supervision of operational risk, including any incremental capital requirements, should be included in the Second Pillar of the Proposal.

D. Risk Transfer and Mitigation

It is fundamental that banks taking action to mitigate their operational risks be rewarded for that action. The range of operational risk mitigation activity is broad but certainly includes activities such as the development of best practices, contingency planning or the maintenance of internal controls. Some of these activities may in fact relate to an existing regulatory standard. Provision should be made within any measurement methodology to recognize the value of this activity and adjust the level of regulatory capital accordingly.

In addition to recognizing the value of risk management activity, any measurement methodology must also be capable of accommodating the value of risk transfer products. It follows logically that if

firms can carry a capital charge for operational risk then they should also receive a regulatory capital gain if they transfer that risk to a third party. This does not seem to be reflected in current regulatory proposals.

Operational risk transfer products are primarily insurance based but also, and increasingly, alternative risk transfer products. MBNA believes that a commitment to take action in this area would be important if a regulatory charge is introduced. It would stimulate investment not just in the current generation of operational risk transfer products but also the development of new products and new markets. This is an area in which positive action from the Committee could create a positive momentum within the industry.

E. Implementation Timeframe

The vast majority of U.S. banks are currently not capable of performing the operational risk quantification required to qualify for the Internal Measurement Approach. MBNA recommends delaying the implementation of the Operational Risk portion of the Proposal until an industry consensus is reached on operational risk measurement and more robust loss data is available. If the Proposal is implemented under the timeframe currently proposed, MBNA believes there would be a disproportionate negative impact, in the form of increased capital levels, for all but the largest and most sophisticated institutions.

V. The Second Pillar – Supervisory Review Process

MBNA generally agrees with the concepts described in the Supervisory Pillar. However, we have major concerns about the regulator's ability to implement the Pillar in a consistent and thorough manner for the many different types of banks across the banking industry. Given the scope and complexity of the proposal, and the limited timeframes for implementation, we question the regulator's ability to gain an appropriate understanding of the proposal and at the same time educate a sufficient number of examiners to evaluate a given bank's capital adequacy program. There should be well-developed examination procedures, education, and technical expertise in place before the Proposal is adopted in the final form. MBNA would also like the opportunity to provide comment on any new proposals.

A. Definition of Risk Management Practices

We agree that banks should improve and better define their risk management practices. We note there is a potential for a significant increase in regulatory burden in the form of additional record keeping, analysis and management reporting under the proposal. Risk management is an all-encompassing concept, and in order to gain a full understanding of large complex banking organizations, examiners need to review and understand all of the component risk areas. This understanding is gained through periodic examinations and reviews of those areas, and requires significant time and effort. We are concerned that there may be an expectation that the capital analyses will need to incorporate the written analysis of the component risk categories into one central document or database. Capital planning, in this instance, may become the de-facto risk management arm of the organization. We believe that it is important to specify that the level of documentation needed to support a given assessment should not be overly burdensome, nor should it be required to be centralized in one place. Management should be given the discretion to summarize

their analysis; however, the regulators should allow the actual risk assessments to be conducted on a decentralized basis.

B. Independent Review

We are very concerned with the requirement that an <u>independent</u> review of the bank's capital adequacy program must be conducted. There is likely to be a shortage of competent, experienced third parties available, including national supervisors, to conduct such an assessment; and requiring the independent review could result in significant additional audit costs for the organization. We would argue in many cases that much of the risk assessment work is being done by both the internal audit and risk management divisions, and as such, should be relied upon in assessing various risks within the capital adequacy assessment.

C. Early Intervention

We fully agree with early intervention strategies on the part of the regulators should they recognize deterioration in either a given bank's capital level or control environment. We are of the opinion that such "triggers" and early intervention criteria should be published in conjunction with the adoption of the proposal and uniformly applied.

D. Supervisory Transparency

We agree with the need for supervisory transparency; however, there should be in place a clear, published set of examination guidelines, uniform examiner education, and uniformity of examination approaches. Regulators should clearly disclose how, and under what circumstances, they would rely on the bank's own assessment program. This could provide banks with an incentive to develop and adhere to a comprehensive internal assessment program.

VI. The Third Pillar – Market Discipline

A. Consistency of Disclosures

In paragraph 13, the Committee notes its intention to work with accounting authorities to promote consistency between accounting disclosures and the disclosures under the Proposal. MBNA believes consistency of disclosures should be a serious part of the Committee's deliberations. Banks will have difficulty implementing the disclosure requirements, and the benefits of any new disclosures will be compromised if the disclosure conflict with or overlap other disclosures required of banks. MBNA believes the new disclosures should be consistent with disclosure requirements of the U.S. Securities and Exchange Commission (SEC), such as Regulations S-K and S-X. To that end, we assume that supervisory authorities will have the flexibility at the national level to provide for consistency among the multiple disclosure regimes to which banks are subjects.

B. Enforcement

At paragraph 16, the Committee recommends providing for direct sanctions, such as not being allowed to apply lower weightings or specific methodologies, when certain core disclosure

requirements are not satisfied. MBNA urges that the standards for determining when such sanctions apply be rigorous and generally applied prospectively. This should particularly be the case with respect to core qualitative disclosures, which may involve significant judgment by banks as to the appropriate scope and detail. MBNA assumes that sanctions applied retroactively would be limited to the most serious disclosure deficiencies, such as intentional or grossly negligent omissions or misstatements of material elements of the disclosures.

C. Core and Supplementary Disclosures

MBNA strongly supports the Committee's comment in paragraph 18 that too much disclosure could blur the key signals that should be clear to the market from such disclosure. Notwithstanding the Committee's apparent belief that the current proposal strikes the correct balance, MBNA respectfully suggests that the level of disclosure contemplated by the current draft of the proposal will produce the result the Committee fears. MBNA strongly urges the Committee to undertake a separate review of the disclosure scheme for the express purpose of making the disclosure requirements as succinct as possible. The standard for inclusion of a disclosure requirement should not be a sense that the information might be of some value to some market element. If the value of a particular disclosure to the market is uncertain and compliance potentially difficult for banks, the disclosure should not be required.

The Committee's distinction between core and supplementary disclosures is helpful. However, the Committee cautions that the supplementary disclosure may be of "great significance" for certain banks and thus "should not be regarded as 'secondary' or 'optional' disclosures." MBNA urges that clearer lines be drawn to determine when core and supplementary disclosures must be applied. Such determinations could be based on asset size, market activity and other relevant factors. Without clearer rules many banks will feel compelled to comply with all supplementary disclosure requirements, notwithstanding their relevance to the bank's capital position.

D. Materiality

In paragraph 20, the Committee sets out a "reasonable investor" test for materiality. This test is similar to the materiality standard used with SEC disclosure requirements. MBNA recommends the Committee (or perhaps more appropriately, the U.S. supervisory agencies in their implementing regulations) adopt more precisely the materiality standard used in securities case law, at least with respect to application of these new requirements within the United States. Under this standard, as recently cited in the SEC adopting release for Regulation FD, information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision, and would view it as "having significantly altered the 'total mix' of information made available." While the two standards may be substantially the same, we see no benefit to stating them using different terminology. To the extent materiality standards vary among countries, the Committee should specifically allow countries to adopt their own materiality standards based on the most appropriate and developed standard accepted in each country. If banks have to apply an unfamiliar materiality standard or one that is inconsistent with accepted standards within their countries, compliance costs will increase. Also, since regulatory enforcement of the disclosure requirements will be executed within each country, such flexibility seems appropriate and necessary.

E. Proprietary Information

In paragraph 21, the Committee notes its concern with respect to protecting banks' proprietary information in any disclosure scheme. It is difficult to evaluate this risk at this early stage in the development of a disclosure system when many details concerning the disclosures have not yet been articulated. Nonetheless, MBNA is concerned that certain general categories of disclosure will involve disclosure of proprietary information which may adversely affect a bank's competitive position. For example, Table 3.1, which describes credit risk disclosures applicable to all institutions, includes a core qualitative disclosure requirement of information on techniques and methods for managing past due loans, and supplementary quantitative and qualitative disclosure of information about credit scoring and credit risk measurement models. Depending on the detail expected for such disclosure requirement, such disclosure could include confidential business strategies. Similarly, certain capital adequacy disclosures in paragraph 82 could involve confidential business plans, such as the disclosure of contingency planning and future capital plans. Indeed, in both instances, it is difficult to imagine that such disclosures would have any value if the detail required did not include proprietary information. A disclosure scheme should not place supervisory authorities in the position of enforcing requirements to which reasonable institutions will be understandably resistant.

F. Frequency of Disclosure

In paragraphs 22 and 23, the Committee recommends semi-annual disclosure; however, the Committee also acknowledges that certain disclosures may be necessary more frequently or less frequently. The Committee also states that it is desirable to have the semi-annual disclosures audited. MBNA strongly urges that the Committee not recommend audited disclosures any more frequently than annually. Most banks have only annual audits of financial disclosures. Requiring additional audits will substantially increase the costs of compliance with the proposal.

The Committee indicates that banks should be encouraged to consider using electronic media to make relevant disclosures on a more frequent basis. We are unclear as to precisely what sort of use of electronic media is contemplated, as it appears to us that the reference is an afterthought. MBNA assumes, given the significance of disclosures, they would be part of a more formal and regularized disclosure regimen by banks, most likely provided in conjunction with annual and/or quarterly reports. The suggestion to use electronic media does not appear to be appropriate for these disclosures.

G. Risk Exposure and Assessment

MBNA questions the usefulness of the *ex-post* performance assessment disclosure required for all risk exposures under the IRB approach (described generally under paragraph 35). The *ex-ante* assessment is essentially a probability model to indicate a bank's estimate of risk. MBNA agrees that such probability models should be validated periodically by the users. However, requiring public disclosure of a specific reconciliation between the probability model and actual results is of limited value and may only serve to confuse the market. There may be valid reasons why results diverged from what was predicted, and such reasons may be quite complex and therefore difficult to explain in any way meaningful to the vast majority of investors. Also, this divergence may not necessarily invalidate the probability model. As an alternative, MBNA recommends that banks be

required to periodically conduct internal validations of the *ex-ante* assessment and that banking examinations include a review of the adequacy of the validation techniques.

Conclusion

MBNA appreciates the opportunity to provide the Committee with comments on the Proposal. We would like to again emphasize our strong opposition to the Proposal. If, despite our opposition, the Committee proceeds with the Proposal, it is absolutely critical for the Committee to invest the time necessary to develop a workable solution. The December deadline should be set aside to permit further analysis and input from everyone affected by this proposal. The Committee should provide for at least another year of development, review and comment in developing a workable Proposal, as well as at least a year delay in implementation of a final accord.

Yours truly,

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MBNA America Bank, N.A.

C:
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Financial Services Authority
Office of the Comptroller of the Currency
Office of the Superintendent of Financial Institutions
Office of Thrift Supervision