National City

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

SUBJECT: The New Basel Capital Accord

Dear Committee Members:

National City Corporation appreciates the opportunity to comment on the January 2001 proposed revisions to the Basel Committee's risk-based capital accord. National City is a financial holding company with total assets of approximately $90 billion and market capitalization of approximately $17 billion.

Our comments in this letter are mainly focused on operational risk and market discipline.

Fundamentally, we agree with the philosophy that operational risk is a significant business issue that needs to be managed, and that a corporation's equity serves as protection against such risk. However, we believe that earnings are ultimately more important than capital in assuring the safety and soundness of a financial institution. While capital may provide a buffer against unexpected operating losses, an earnings impairment and the resulting (often exaggerated) impact on share price are far more likely to limit a financial institution's flexibility and thus potentially threaten the safety and soundness of the organization. Alternatively, an institution's ability to consistently generate strong earnings and access liquidity are the primary hedges against periodic loss events. For this reason, we believe that any methodology to assign capital to operating risk should be simple, balanced and cost effective.

The proposal asked specifically for comments on the definition of operating risk. The proposed definition is extremely broad, but we believe reasonable, given that operating risk by its very nature will be different for every organization based upon its business characteristics. The real issue is not so much the definition as the resulting segmentation and quantification of the specific risks, as well as the available risk hedges.

The statement in the proposal that "expected" losses should be covered by current earnings and that "unexpected" losses should be covered by capital is confusing. We interpret these definitions to mirror U.S. regulatory definitions on inherent risk ("unexpected losses") and dynamic risk ("expected losses"). However, if this is the intended meaning, it is very possible to have a dynamic risk that could take years to resolve (i.e. litigation) and not record an earnings charge and balance sheet reserve. Likewise, an inherent risk could conceivably manifest itself as an issue that is quickly recorded as an earnings charge, essentially doubling the impact on equity (i.e. existence of a capital allocation as well as a balance sheet reserve). If our presumption of the definition of these items is inaccurate, then we would need specific guidance as to the meaning of these risk terms. Either way, the definitions are likely too broad in their

present form to have consistency among financial institutions in their interpretation and ultimate implementation.

Our present internal capital allocation models collectively evaluate all known risk (i.e. operating, credit and market) at a product level using an earnings-at-risk framework. It appears the more sophisticated proposed Basel models are headed toward a more refined calculation with focus on specific risk. While both inherent and dynamic risks exist in any business, a position could be taken that no loss is ever "expected", especially if the risk is adequately managed. U.S. accounting rules currently require that a reserve be established for a risk when a loss event is known, estimable, and probable of incurrence. Arguably such reserves should be included in regulatory capital and no further consideration need be given. A second type of risk can also exist where the risk event may be known, but not reasonably estimable or able to be assessed as to probability. Examples could be early stage litigation or items subject to tax audit. Instead of developing an arbitrary or actuarial calculation to assign capital, a reserve similar to those recorded for risks that are booked under the accounting rules could be assigned for these specific, less-known exposures in the regulatory capital calculation. This approach would mirror the current capital calculations where capital is assigned according to the nature of on-balance sheet assets.

We are concerned that developing models at a base level may be very expensive and provide no better result than what exists today. Also, as the models continue to drill down to a base level, the potential exists that some risks could be overlooked in the calculation. For this reason, as well as cost/benefit, we have elected to use a model that looks at risks collectively and focuses on earnings-at-risk. Another potential challenge with the proposed detailed calculations is that internal models for some products may suggest capital levels are required that are below prescribed regulatory floors, but there is no ability to implement these levels and thus minimal cost/benefit balance for even making the calculation. Further, if implemented, this proposal is more likely headed toward increased capital requirements for many institutions, creating real economic effects through potential dividend limitations and increased need for alternative funding. In cases where real risk is evident this outcome may be appropriate, but earnings, performance and stock price would be unnecessarily impaired where the extra capital is excessive.

Theoretical arguments can be made and actuarial or econometric models developed at some cost to predict possible losses based upon operational risk. We believe the real weakness in the proposed rules are the lack of development of offsets or risk management activities that can serve to mitigate losses or protect capital. A bank returning 20% on equity could replenish its entire capital base in a five-year period. Insurance policies are in place to establish reasonable loss limitations. Other hedging strategies may be in place, dividends could be reduced and other tools may serve to offset risk. It is unclear how these issues are to be considered in the calculation of regulatory capital. Further, if these strategies produce a result suggesting capital could be held below the regulatory floor, it does not appear that reduced capital allocations can be considered. In contrast, our internal capital allocation models capture the impact of the risk management activities through a reduction in earnings volatility. While we adjust our total allocated economic capital up to what we consider a conservative level overall, we will assign somewhat less economic capital to some product and lines-of-business than the amended 1988 Basel guidelines would direct, based upon our economic risk analysis.

The proposal seems to indicate that banks should employ the most sophisticated approach to quantifying risk as possible. Arguably, most institutions understand the qualitative aspects of operational risk. Adding a quantitative element, especially under an internal ratings-based approach, has the potential to add significant personnel and systems costs. Further, the proposal implies and recent regulatory activity suggests that highly redundant levels of risk management oversight will be required in order to use the internally-developed risk models. For the reasons discussed above we do not believe that the additional cost is worth the perceived benefit and that the resources are much better spent on identifying and managing risk than on calculating precise theoretical capital needs. Further, increasing the sophistication of actuarial and econometric models leads intrinsically to higher levels of model risk. While the risk can be mitigated through substantial effort, it cannot be entirely eliminated. For all of the reasons stated, we believe a supervisory approach to managing operating risk should be implemented. This would also be consistent with Basel's Pillar 2 interest rate risk approach.

There are two other elements of the proposal that we find troubling:

- It appears that an arbitrary level of 20% has been set regarding the component of total capital that is applicable to operating risk. Given that no two institutions have identical risk profiles, it would seem that a flat calculation would be inappropriate.

- Secondly, while operating risk will differ among banks, there should still be some element of consistency in the capital calculations. Given some of the broad definitions and arbitrary calculations in the proposal, we believe consistency/comparability will be difficult to achieve.

<u>Market Discipline</u>

There is no question that the market is a far more effective regulator and enforcer of capital standards than supervisory authorities. No amount of capital can protect a bank from loss of confidence.

Investor confidence is not a function of any single variable but rather is fostered over time by a combination of factors, including operating history, perceived balance sheet strength, general economic conditions, quality of management, and access to information.

As is the case with all U.S. banks, National City, by virtue of being a Securities and Exchange Commission (SEC) registrant, is already subject to the most extensive and rigorous disclosure requirements in the world. A major concern of ours would be a new set of disclosure requirements, additive and not harmonized with existing generally accepted accounting principles (GAAP) and SEC requirements.

Quantity of disclosure does not necessarily correlate with quality of disclosure. We are concerned about the sheer volume of the proposed disclosures. The process of risk management is not just a statistical function, but involves significant amounts of judgment. Statistical tables, no matter how voluminous, cannot offset lack of good judgment on the part of management. The

paradox of disclosure is that more can be less, because excessive disclosure impedes timeliness and frustrates the ability of market participants to absorb relevant information quickly.

Much if not most of the information called for is already furnished in some manner to rating agencies, who also conduct due diligence reviews of management competency and processes in assigning debt ratings to a bank or holding company. That information flow is nearly continuous and is reviewed and discussed in context. It is unrealistic to think that a single set of financial statement disclosures can replicate the outcomes of a rating agency process, especially with regard to comparability among companies.

As a summary comment on market discipline, we applaud the concept and the salutary effects of full disclosure, but respectfully suggest that the U.S. debt and equity markets, supported by the existing SEC/GAAP reporting systems, already exert that discipline. We believe it is better to start with that solid foundation rather than to churn out mass quantities of data at the expense of insight and timeliness.

Other Matters

In general, we are concerned about provisions of the proposal that appear to increase capital requirements in an arbitrary and duplicative fashion. An important example is the *w* factor used to discount credit exposures mitigated by derivatives, guarantees or other standard risk management instruments. Reducing collateral by 15%, presumably after expected losses have been appropriately calculated, essentially provides for an extra (and arbitrary) capital cushion. This runs counter to the whole intention of the proposal, which is to more appropriately allocate capital to risk assets. As a result, the benefit from a more efficient allocation of capital is diminished. A related example is the minimum capital requirement for securitized assets under the "managed assets approach." This requirement would be duplicative of capital already required under most countries bank regulatory structures for sales with recourse.

Finally, the December deadline for publication appears to be too aggressive given the complexity of the matters at hand. With regard to securitizations, several important elements of the approach, including the internal ratings-based approach discussions and proposals for synthetic securitizations, have not yet been formally exposed for comment. Once exposed, additional time will be needed for analysis and comment.

Once again, thank you for the opportunity to submit comments.

Sincerely,

Jeffrey D. Kelly
Executive Vice President
and Chief Financial Officer

JDK:sst