May 31, 2001

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

Re: The Proposed New Basel Capital Accord

Ladies and Gentlemen:

The member banks of The New York Clearing House Association L.L.C. (the "Clearing House")[1] appreciate the opportunity to comment on the consultative paper by the Basel Committee on Banking Supervision (the "Committee") concerning *The New Basel Capital Accord* (the "Proposal").

The Clearing House has eagerly awaited the Committee's proposed new regulatory capital framework, anticipating that it would reflect industry assessments of economic capital by incorporating more risk sensitive capital charges. We believe, however, that the Proposal does not achieve this objective in a number of key respects. The Clearing House acknowledges that the Proposal makes positive advances in a number of areas, but we believe that — without substantial revision — implementation of the Proposal could have potentially significant negative

1 The member banks of the Clearing House are: Bank of America, N.A.; The Bank of New York; Bank One, N.A.; Bankers Trust Company; The Chase Manhattan Bank; Citibank, N.A.; European American Bank; First Union National Bank; Fleet National Bank; HSBC Bank USA; Morgan Guaranty Trust Company of New York; and Wells Fargo Bank, N.A.

consequences for the financial services industry and the economy.

At the outset, the Clearing House banks believe, based on their own portfolio analyses, that their capital requirements under the Proposal would be significantly higher than current requirements. Likewise, the Clearing House banks believe that the Quantitative Impact Study will show, as discussed in greater detail below, materially higher capital requirements for the industry as a whole.

We are convinced that a significant increase in capital requirements is unmerited and excessive. The inevitable impact would be an increase in the cost, and, to some extent, a decrease in the supply of credit and liquidity to the economy. Moreover, the Clearing House wishes to stress that excessive capital requirements may negatively effect the safety and soundness of the financial system through the unintended effects of disintermediation and regulatory arbitrage.

More specifically, the Clearing House is of the view that the proposed new capital regime has several fundamental flaws that must be dealt with before the Proposal can be implemented.

First, the Pillar 1 capital calibrations are unduly conservative, result in minimum regulatory capital requirements that are significantly higher than current regulatory capital requirements and are not economically justified.

Second, the Proposal does not assure competitive equality between banking organizations and nonbank financial services providers.

Third, the treatment of credit risk mitigation techniques is overly conservative and could undermine the Committee's objective of achieving a closer correlation between risk and capital. In particular, the introduction of the "w" factor is misguided and unwarranted and could discourage the use of credit risk mitigation techniques.

Fourth, the inclusion of operational risk in the new regulatory capital framework is difficult to evaluate at this time given the lack of details in the Proposal. The quantitative measurement of operational risk by the banking industry is in its development stages and is, therefore, imprecise, and we are concerned that the Proposal's approach may result in significant overlap with measurements for credit and market risk. We therefore urge the Committee to continue its efforts, in conjunction with the banking industry, to further develop and refine operational risk methodologies and practices.

Fifth, the Clearing House opposes the two floors imposed under the internal ratings based ("IRB") approach: the 90% of the foundation approach floor applicable for the first two years and the three basis point minimum probability of default ("PD") floor for the highest ratings categories.

Finally, the Clearing House believes that the disclosures suggested by the Proposal are excessive and would not provide investors with a demonstrable benefit or further a significant supervisory objective that would justify the cost of the additional disclosures.

The need to resolve these fundamental problems and the timing of implementation of a new capital regime are closely interrelated. The Clearing House is hopeful that

the Proposal can be modified within a reasonable timeframe to provide a sound long-term basis for capital requirements. The Committee must recognize, however, that the rules contained in the Proposal constitute a major overhaul of the capital adequacy framework applicable to banks and that the Proposal will most likely apply for many years. Therefore, it is essential that the Proposal not be adopted until all material problems are resolved either directly or by allowing sufficient flexibility to both banking organizations and their supervisors, recognizing that best practices are still evolving in many areas.

In this regard, we note that the Committee has yet to publish interim papers in such key areas as operational risk, retail credit, project finance, and equity investing. The Clearing House urges the Committee to delay finalization of the Proposal until the industry has an opportunity to comment on a subsequent draft of the Proposal that would address both the issues discussed herein in more detail, and the numerous issues that are likely to be raised in these additional publications.

A number of our member banks are submitting extensive individual comment letters, which the Clearing House fully endorses. We are writing to bring the following general concerns to the Committee's attention:

1. Overall Calibration of Capital Charges.

The Clearing House banks believe that the Proposal would result in capital requirements that are drastically higher than current requirements and that are not merited by the banks' internal economic capital analyses. This result would be contrary to the Proposal's stated objectives in two crucial respects. First, the Committee's stated objective

is to "deliver a more risk-sensitive standardised approach that on average neither raises nor lowers regulatory capital for internationally active banks." Executive Summary of the Proposal, Paragraph 7. Second, the Proposal was intended to place greater emphasis on banks' own assessments of the risks to which they are exposed in the calculation of regulatory charges. Executive Summary of the Proposal, Paragraph 5. It is the view of the Clearing House banks that regulatory capital requirements should be true minimum standards and should never be viewed as a substitute for a bank’s own assessment of its internal capital requirements.

Accordingly, in calibrating Pillar 1 capital requirements, the Committee should strive to ensure that the regulatory standard is not unduly conservative. Yet, in a number of crucial respects, the proposed computation methods set forth in the Proposal do not achieve this objective.

For example, the Clearing House banks are concerned about the inclusion of a multiplier in the formula for the IRB approach. Overall, the multiplier has the effect of increasing the minimum standards for credit risk. The Clearing House banks believe such an increase is inappropriate, given the consequences under prompt corrective action rules in the United States and the financial holding company qualification rules under the Gramm-Leach-Bliley Act if a banking organization does not maintain well-capitalized status.

The Committee suggests that the multiplier is necessitated by banks' credit risk measurement errors. The Clearing House banks disagree. We do not believe there is any justification for the Committee to assume that banks routinely underestimate risk in the calibration of Pillar 1

capital requirements. Banks are subject to internal checks and balances, rating agency reviews, analyst and investor evaluations of their performance, and supervisory assessments, all of which work to prevent biases in either direction. We believe that Pillar 2 is the appropriate vehicle to address supervisors' concern that individual banks are underestimating their credit risk.

As a second example, analyses by the Clearing House banks indicate that the calibration of the capital requirements for retail assets is too onerous. The Committee states that it attempted to calibrate capital for retail assets to be approximately half of that for wholesale assets, whereas our member banks observe ratios of capital for retail assets to capital for wholesale assets that are considerably lower. Furthermore, the proposed retail capital function includes the multiplier referred to above and incorporates correlations that are significantly higher than our member banks observe. The Clearing House banks do not consider the ratios of proposed required capital to internal capital to be consistent with a minimum regulatory standard.

As a third example of the Committee's unduly conservative approach to calibrating Pillar 1 capital requirements, the Clearing House banks wish to point out that the capital required for sub-investment grade corporate assets is considerably less under the standardized approach than under the IRB approach.[2] By setting the capital at drastically different levels, the Committee creates a disincentive for banks to use the more advanced techniques

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2 Under the standardized approach, the highest amount of capital required for sub-investment grade assets is 12% compared to a range of approximately 15-20% for similarly rated assets under the internal ratings-based approach.

available under the Proposal, which are much more sensitive to the risk inherent in low-grade assets.

As a separate but related matter, the Clearing House believes that the Pillar 1 capital requirements should not cover both expected and unexpected losses. The inclusion of expected losses without appropriate adjustments to the definition of total capital is a conceptual flaw in the Proposal. In the case of credit and other risks, expected losses are largely covered by reserves. An additional regulatory capital charge would double count the risk of the expected loss exposure and result in a systematic overstatement of risk and capital. This imbalance creates punitive capital requirements in businesses with higher expected losses, such as credit cards and some consumer lending, without taking into account the fairly stable, i.e., less volatile, expected loss experience of such businesses.

The Clearing House strongly urges the Committee to apply regulatory capital requirements to cover unexpected losses only. Such an approach would conform to the way most banks view capital and would allow for flexible approaches in the treatment of expected losses.

Should the Committee decide that risk-weighted assets are to reflect both expected and unexpected losses, it would be necessary, at a minimum, for the Committee to amend the definition of capital 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 put banks at a

disadvantage if they were to take specific provisions for portions of extremely low quality or defaulted assets. The Banks should not be required to hold capital for assets where they have already established an adequate financial cushion.

Requiring banking organizations to hold more capital than economically justified would effectively result in higher costs to the users of funds from organizations that would be subject to the New Basel Capital Accord. This impact would be felt especially by those customers that rely primarily on banking organizations for their funding needs. Assuming other factors remain constant, a higher cost of funds would likely result in fewer investment projects, with the corresponding potential consequences in the growth of investment in economies.

2. Competitive Equality.

The Clearing House believes that, consistent with the goal of competitive equality, the Committee's ultimate goal should be a consolidated regulatory capital approach. In its current form, the Proposal restricts the ability of banking organizations to compete with non-bank financial services companies by eliminating insurance businesses, requiring the deconsolidation of significant financial and nonfinancial investments, and imposing excessive capital requirements. This result would be wholly inconsistent with the stated goal of competitive equality. Although the Proposal offers flexibility in how a national supervisor could interpret the scope of the Proposal, the breadth and reach of the Proposal will make it nearly impossible to avoid creating regulatory conflicts and arbitrage incentives.

There are several difficulties with the Proposal that may make it impossible to ensure competitive equality. The Proposal establishes capital requirements in the securities, asset management, and cash settlement businesses that differ sharply from those of non-bank competitors. The Clearing House banks believe that this inequality could be disruptive to competitive markets and could limit a banking organization’s ability to provide liquidity and services to certain markets. Depending on how national supervisors interpret the scope of the Proposal, banks could be at a significant disadvantage against competitors that are not subject to these rules.

If the new capital requirements make banking organizations less competitive, there will inevitably be some withdrawal from the market. As supervisors are well aware, markets tend to become less competitive as participants withdraw. Additionally, to the extent that capital requirements impede bank participation in financial markets, it is a strong likelihood that any new entrants to the market would be non-bank organizations not subject to the Proposal.

3. Credit Risk Mitigation.

The use of credit risk mitigation techniques, such as credit derivatives and collateralization, have increased significantly over the last several years. The Clearing House banks strongly support the Committee's intention to promote the greater use of these techniques through improved capital treatment in the Proposal. The Clearing House banks 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, which could undermine the closer link between risk and capital the Committee is trying to achieve.

The Clearing House banks believe that the haircuts and "w" framework for incorporating the risk mitigation effects of various forms of collateral, guaranties, and credit derivatives do not strike a reasonable balance between recognizing additional aspects of credit risk mitigation and providing safeguards against residual risks. The haircuts and "w" framework misalign risk and regulatory capital and are arbitrary, uneconomic, and inconsistent with current bank practices and risk-management systems. They thereby discourage banks’ use of credit risk mitigation techniques, which is counterproductive to safety and soundness.

In the view of the Clearing House banks, the Committee did not clearly articulate the purpose of the "w" factor, especially in the context of credit derivatives. As understood by the Clearing House banks, "w" is meant to capture residual risks stemming from legal and documentation concerns and to focus banks on the credit quality of protection sellers. The "w" factor is not warranted on these grounds. Credit derivatives transactions are generally governed by well-established master documentation that is legally enforceable if properly authorized and executed. A number of industry bodies have promoted the use of standardized documentation for credit derivatives in order to improve legal certainty and enhance liquidity in the market. Credit derivatives pricing does not take into account legal risk, which indicates that the market relies on the adequacy of the documentation used. Furthermore, the minimum standards for recognition of the risk mitigation

effects of collateral, guaranties and credit derivatives, including legal robustness, are in themselves sufficient to ensure that the legal risk inherent to these forms of credit risk mitigation is minimal. It cannot therefore be argued that a credit derivatives transaction is subject to greater documentation or legal risk than any other kind of commercial transaction entered into by a bank.

The adverse implication of the imposition of the "w" factor on the Proposal's treatment of credit risk mitigation is compounded by the fact that the Proposal does not recognize the benefits of the so-called “joint default” effect, which recognizes that banks only suffer losses in guaranteed transactions when both the obligor and the guarantor default. The Committee itself states that the joint default effect can reduce the credit risk to which a bank is exposed if there is a low correlation between the default probabilities of the obligor and the guarantor. Executive Summary of the Proposal, Paragraph 89. The Clearing House banks 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.

The Clearing House banks strongly urge the Committee to eliminate the "w" factor. Applying a blunt instrument such as "w" to credit risk mitigation techniques seems contrary to the Committee's stated goal to deliver a more risk-sensitive methodology that neither raises nor lowers overall regulatory capital for financial institutions and motivates financial institutions to improve their risk management practices.

Both the standardized approach and the foundation IRB 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 IRB approach, not just those qualifying for the advanced IRB approach, to set their own haircuts on a portfolio basis (by counterparty), including correlations between the underlying exposure and the collateral.

The Proposal uses a ten-day holding period as the base case for calibrating the standard collateral haircuts and the ten-day holding period is also imposed as a parameter for banks setting their own haircuts under the advanced IRB approach. In general, the Clearing House banks believe any haircuts should reflect the period during which the bank is subject to the volatility of the collateral it is holding. In particular, given market practice and the strong legal underpinnings of repurchase and securities lending transactions, a ten-day holding period assumption for such transactions is inappropriate. Three days would be a more reasonable assumption for securities lending transactions given the daily margining process and the short time required to liquidate collateral.

4. <u>Operational Risk</u>.

The Clearing House banks welcome the Committee's initiative to include specific measures governing operational risk in the scope of the Proposal. This

initiative has mobilized the banking industry to action, has initiated a significant effort to develop improved risk measurement techniques and identify industry best practices, and has facilitated a debate that will serve to enhance the quality of operational risk management. The Clearing House banks 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 during the years to come as the industry and the regulatory community work collectively to refine the understanding of operational risk and to establish an appropriate regulatory framework for this risk category.

At this point, however, quantitative measurement of operational risk within the industry is still in its infancy. Most banks have not captured the data necessary to adequately evaluate operational risk separately from credit or market risk. As a result, portions of the historical loss experience resulting from operational risk is reflected in the loss experience data reported for credit and market risk. To avoid double counting, any separate capital requirement established for operational risk must recognize this data overlap. The new system must allow for a transition that takes account of this historical data collection issue.

The benchmark calibrations for operational risk in the Proposal are excessive and do not reflect the risk-mitigating benefits of diversity and scale. The failure to recognize these mitigating effects would result in a significant unnecessary increase in banks' capital requirements. These issues are too important and the risks

of prescribing any specific process without allowing sufficient time for further research are too great to impose capital requirements for operational risk without substantial further consideration. This holds true for both the quantification of operational risk and for the recognition of risk-mitigation practices such as insurance, automation, and outsourcing, which should also be included in any regulatory capital framework for operational risk. For this reason, the Clearing House banks urge the Committee to continue its efforts, in conjunction with the banking industry, to further develop and refine operational risk methodologies and practices.

With regard to the level of capital required for operational risk relative to other risks, the Clearing House banks believe that a level of 20% of capital allocated to operational risk will generally be too high for banks, and in some cases will be considerably too high.

5. Limitations on the Benefit from Use of the Advanced IRB Approach.

The Clearing House banks are particularly concerned with two floors imposed pursuant to the IRB approach. First, for the first two years following implementation, the capital required under the advanced IRB approach may not fall below 90% of the capital required under the foundation IRB approach.

The Clearing House banks maintain that no rationale exist for imposing such a floor. If a bank 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 IRB approach, then the supervisor should be willing to

accept the bank's resulting calculation of minimum capital requirements. To impose such a floor would result in banks having to calculate their regulatory capital twice quarterly over a two-year period, at a multi-million dollar cost, with no compelling safety and soundness benefit. The Clearing House banks strongly recommend that the Committee eliminate the 90% floor. If the Committee retains such a floor, it should also introduce a cap on how much greater the advanced IRB approach could be as compared to the foundation approach.

The second floor imposes a minimum PD of three basis points for the highest ratings categories. The Clearing House banks believe that banks should be allowed to use a lower PD estimate if they can provide the appropriate analytical support for doing so.

6. Disclosure.

The Clearing House banks strongly believe that the guiding principle for imposing additional disclosure requirements on the banking system should be that such disclosure either provides a demonstrable benefit to investors or furthers a significant supervisory objective. The Clearing House respectfully submits that many of the disclosures suggested by the Proposal would not be consistent with this guiding principle. Moreover, the Proposal does not address serious competitive issues that would arise from imposing such requirements on the banking industry.

In addition, the Clearing House banks wish to note several specific concerns with the disclosure requirements set forth under Pillar 3 (Market Discipline).

First, the Committee appears to assume that more information relating to risk will necessarily improve market discipline. In fact, the Clearing House banks believe that the proposed disclosure requirements would impose a tremendous burden without providing commensurate enhancements in risk transparency.

In order for the disclosure mechanism to function effectively, the user must be able to understand and act on the information provided. Given the dramatic increase, both in scope and complexity, of available information in the public domain and the dynamic changes in bank portfolios, disclosures become outdated almost instantaneously, which renders it nearly impossible for a user to have up-to-date information with regard to a bank's risk profile.

Second, it should be noted that market discipline does not depend entirely on public disclosure. Rating agencies, for example, have privileged access to complex and sensitive information that would not be accessible to most users of public disclosures.

Third, many of the proposed disclosures would not in our view meet the materiality test established by the Committee. Under that test, information would be considered material if its "omission or misstatement could change or influence the assessment or decision of a user." The Pillar 3 (Market Discipline) Supporting Document to the Proposal, Paragraph 20. Using this definition, it is hard to contemplate, for example, why it would be critical to disclose "summary statistics of distribution of (actual) LGD, such as standard deviation and 10th, 50th and 90th percentile at default at 1, 2, and 3 year intervals and weighted with exposure.” The Clearing House banks question

whether the assessment of a bank's credit risk management and measurement skills by readers of a bank’s financial statements could actually be “changed or influenced” by this information, especially considering the availability of other relevant information.

Fourth, the new disclosures set forth in the Proposal, particularly those with regard to internal ratings and operational risk, greatly exceed current disclosure requirements in jurisdictions with the most advanced accounting and disclosure standards. The proposed disclosures would force banking organizations to disclose information that their key non-bank competitors, which are subject to similar risks, would not be required to disclose. The Proposal requires disclosure of detail to such an extent that confidential customer data and proprietary competitive data would necessarily be exposed. The proposed credit risk disclosures focus on a single approach to assessing potential loss and do not address the timely identification and recognition of credit problems across all banks and non-bank competitors.

Fifth, the new disclosures would impose a substantial burden on banks. The Committee mistakenly suggests that, as banks already collect the required information for internal purposes, the additional cost in making these disclosures should be negligible. On the contrary, it is an immense undertaking to produce audit-quality financial statements, and it would be equally daunting to ensure that the new credit and operational risk data, and their impact on banks’ overall performance, would be properly reflected and understood.

Finally, the Committee's new disclosure requirements are incompatible 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. These groups reviewed industry practices with regard to disclosures and considered several potential enhancements to these practices. The Shipley Group and the Fisher Group subsequently proposed a set of advanced recommendations in accordance with principles adopted by both groups, principles that embody an evolutionary approach to future risk management disclosure practices. In contrast, the Committee's proposals for new disclosures are excessive and cannot be considered evolutionary.

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The Clearing House wishes to reiterate its request that the Committee delay finalization of the Proposal until the industry has an opportunity to comment on a subsequent draft of the Proposal that would address both the issues discussed herein, and the numerous issues that are likely to be raised in the yet unpublished interim papers of the Committee with regard to several key areas of concern to the Clearing House banks.

The Clearing House appreciates the opportunity to comment on the Proposal and would be pleased to discuss any of the points made herein in more detail. If you have any questions, please contact Norman R. Nelson, General Counsel, at (212) 612-9205.

Sincerely yours,

cc: Board of Governors of the Federal Reserve System

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