May 31, 2001

Mrs. Daniele Nouy
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel, Switzerland

Mr. Richard Spillenkothen
Director of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System
20th and C Streets, N.W.
Washington, DC 20551

Dear Mrs. Nouy and Mr. Spillenkothen:

The New York State Banking Department (the Department) appreciates the opportunity to respond to the consultative document, *The New Basel Capital Accord* (the New Accord). The Department recognizes the significant efforts made by the Basel Committee on Banking Supervision (the Committee), and commends the Committee for its movement toward internal models for complex banks. The Department urges the Committee to incorporate more of the Department's recommendations from its April 10, 2000 letter to the previous consultative paper. The underlying philosophy and specific suggestions in the Department's April 2000 letter remain valid and worthy of reconsideration.

To assist the Committee in the context of the New Accord, the following comments focus on details in that document.

- **Apply the New Accord only to complex banks.**

The Committee's incentives to encourage banks to move toward a more sophisticated, model-driven approach to risk management may not be appropriate for all banks. Non-complex banks might have to hold more capital under the standardized approach of the New Accord, since banks whose exposures are to

unrated entities will not be able to take advantage of the lower risk weight buckets and the Committee proposes an additional operational risk capital charge.

Efforts to better reflect risk sensitivity come at the price of greater complexity and consumption of time to understand and implement the New Accord. The New Accord's benefits may not justify the costs required for adoption for the vast majority of banks. The Committee should consider both the regulatory burden imposed by the New Accord and the current capital amounts held by non-complex institutions. All banks other than the most complex should be given the option to retain the existing accord or more simplified alternatives.

- **Expand Quantitative Impact Study.**

The Department is encouraged by the Committee's Quantitative Impact Study, which asks large complex banks for specific information about capital calculations under proposed and current capital requirements. However, unless non-complex banks are excluded from the New Accord as previously recommended, the Department urges that such institutions also be included in the Quantitative Impact Study. A focused study of the New Accord's effects on non-complex institutions should be conducted before new standards are implemented for these institutions.

- **Refine operational risk.**

Both the Basic Indicator Approach and the Standardized Approach are calibrated to the average economic capital for operational risk reported in the aforementioned survey. As such, the operational risk multipliers alpha for the Basic Indicator Approach and beta for the business lines under the Standardized Approach are chosen so the total capital charge for operational risk is 20 percent of minimum regulatory capital. This calibration provides no incentive for non-complex banks to move from the Basic Indicator Approach to the Standardized Approach. Since the Basic Indicator Approach is intended for smaller banks, and since survey data has come from large complex banks, operational risk data must be collected for non-complex banks before these multipliers are set.

Further, the exposure indicators chosen by the Committee do not adequately reflect an increased presence of operational risk. They are, by the Committee's admission, indicators of activity in various business lines. However, increased activity is not equivalent to increased risk. This is especially clear for the exposure indicator chosen for the Basic Indicator Approach -- gross income -- defined as net interest income plus net non-interest income, exclusive of extraordinary or irregular items. The Department suggests that net non-interest income be given greater weight than interest income. A heavier weighting would align the operational risk charge more closely with operational risk, as custody, payments, securities lending, trading, and trust business lines have been identified as high risk for operational loss events.

The exposure indicators for the Standardized Approach also do not adequately reflect an increased likelihood of operational loss. The Committee suggests that increasing alpha relative to the beta multipliers would make the Standardized Approach more attractive. However, this would unfairly penalize smaller banks using the Basic Indicator Approach. Finally, if the Committee ties the operational risk charge to gross activity indicators rather than measures of operational risk sensitivity, and a floor is imposed, the operational risk charge will not encourage improved risk management.

The Department supports the Committee's efforts to encourage banks to collect operational loss data and develop operational risk management methodologies. The Department suggests that further investigation include assessments by supervisors and internal and external auditors. Until operational risk databases are established and widely available and operational risk models are developed further, qualitative judgements can provide incentives to encourage improved operational risk management.

- **Eliminate proposal to deduct investments in commercial entities from banks' capital when such investments exceed certain materiality levels.**

The Department's supervised institutions have a long history of successfully investing in commercial entities both in the United States and abroad. Such investments have not led to bank failures or even downgrades. The Department recommends that investments in commercial entities be risk-weighted at no greater than 250 percent. This would provide additional safeguards on these investments without taking a punitive approach against current and future investments.

- **Choose second option for claims on banks under the standardized approach to credit risk.**

The Department prefers the second option, with a risk weighting based on the external credit assessment of the bank itself. This is superior to the first option, where risk weights are placed one category less favorable than that assigned to claims on the sovereign of incorporation. The second option is more risk sensitive, and recognizes there may not be a correlation between the creditworthiness of a bank and its home country.

- **Revise risk weighting under the standardized approach to credit risk for claims on corporates.**

The risk weights for claims on corporates under the standardized approach are flawed as BB credits are non-investment grade and have higher default and loss characteristics than BBB. Professors Altman and Saunders of the Stern School of Business reviewed twenty years of loss data on credit assets and proposed the following weights: 10 percent for AAA to AA, 30 percent for A+ to BBB, 100 percent for BB+ to B-, and 150 percent below B-. There would be no unrated class since by

definition the bank must risk rate every corporate credit. The Committee should compare this study against the New Accord's risk weights.

- **<u>Permit additional on-balance-sheet netting.</u>**

The New Accord's proposal to limit on-balance-sheet netting to loans and deposits with a single counterparty should be expanded to provide incentives to resolve uncertainties and reduce counterparty risk. Netting should be permitted as allowed under U.S. generally accepted accounting principles. Such principles permit netting when certain criteria are met, most notably when the right of setoff between two parties is enforceable at law, and when a master netting arrangement is established between two parties. These criteria enhance risk management by compelling banks to ensure that amounts can be legally netted. Alternatively, the Committee could follow international accounting standards on netting, which closely resemble U.S. principles.

- **<u>Allow banks to use their own internal estimates of effective maturity and the effects of maturity on portfolio credit risk.</u>**

These advances would further the development of internal models and be more sensitive to risk than an arbitrary three-year maturity standard. Banks should be given the option to use their own estimates or the prescribed standard. Internal estimates would be subject to supervisory review. Unacceptable estimates as defined by the supervisor would result in the supervisor requiring the bank to follow the standard approach and disclose the termination of internal estimates.

- **<u>Clarify collateral treatment under the standardized approach.</u>**

Several aspects require clarification:

(1) The Committee presents the ten-day standard supervisory haircuts without explaining their derivation and relation to historical volatility of rated instruments of the specified grades and maturities. Also, no rationale is provided for the floor, "w."

(2) Collateral classified below specified ratings are ineligible for recognition, while ratings lower than those specified for collateral are within the same bucket for corresponding claims. No explanation is provided.

(3) Supervisors may assign a haircut of zero if the counterparty is a *"core market participant."* The Committee offers no rationale for granting this favorable treatment to only some counterparties with a risk weight of 20 percent.

(4) Paragraph 162 in the supporting document on the standardized approach to credit risk states*: "Where a supervisor applies a specific carve-out to repo-style transactions in securities issued by its domestic government, then other supervisors may choose to allow banks incorporated in their jurisdiction to adopt the same approach to the same*

transactions." This paragraph seems to conflict with the principle that capital requirements will be set on a consolidated basis, and may lead to differential treatment of similar transactions from country to country.

- **<u>Fully disclose the Committee's underlying assumptions in creating the internal ratings-based (IRB) approach.</u>**

The Department applauds the Committee's work to develop theoretical underpinnings for the IRB approach. However, it is unfortunate that the fixed numbers in the formulas for the maturity adjustment and the granularity add-on are presented with little explanation of the theory behind them. If these terms arose from fitting the output of a few specific models that were in use in 2000 rather than from a well-developed theory of credit risk, these formulas may have limited relevance when the New Accord is implemented in 2004. A firmer foundation in theory, even if that meant simpler or less sophisticated formulas, would be preferable.

A key pillar in the Committee's work is market discipline, which depends on adequate and accurate disclosures. In that vein, the Committee should consider elaborating on the assumptions and empirical evidence behind the IRB approach to set a good example of disclosures necessary for the market to operate as efficiently in this area as the Committee expects it to operate elsewhere.

The Committee points to data availability problems and the difficulty supervisors will have in validating portfolio models as reasons to continue calculating a portfolio capital charge based on individual instruments and to preclude the use of full portfolio models. Unfortunately, commercial models currently in use are consistent with a risk bucket approach only if one assumes a single systematic risk factor for the models. As such, concentration effects are lost along with local and industry risk factors. The proposed granularity add-on for the bank's non-retail portfolio addresses concentration by a small number of obligors, but does not address industry, geography, or other systemic concentrations.

On the whole, the IRB approach is a consistent attempt to reconcile various regulatory requirements and present a uniform methodology across institutions and countries. However, documentation is minimal, and the derivation and motivation for the formulas chosen for the capital charge could be determined only by researching other papers and questioning researchers who worked on the New Accord. This should not be necessary. The New Accord is an extremely important document, and details of these calculations have to be absorbed and implemented. This becomes more difficult as the document is less than candid or transparent in its presentation.

- **<u>Revise benchmark risk weights for IRB approaches.</u>**

The benchmark risk weight capital charge is scaled to be consistent with the standardized approach. A corporate loan with a three-year default probability of .7 percent and a loss given default of 50 percent has a risk weight of 100 percent,

making it analogous to a facility rated BBB+ to BB- in the standardized approach. Average cumulative three-year default rates published by Moody's for instruments rated between 1983 and 2000 range from .53 percent for Baa1 rated instruments to 11.68 percent for Ba3 rated instruments. Similarly, Standard and Poor's has published average cumulative default rates for BBB and BB grades, where the average cumulative default rates in year three are .79 percent and 5.35 percent, respectively. This means that a claim with a probability of default (PD) of 1 percent would have a risk weight of 125 percent, and a claim with a PD of 5 percent would have a risk weight of 331 percent. Both PDs are well within 3-year average cumulative default rates for Moody's Baa2 to Ba3 grades and the Standard and Poor's BBB to BB grades. This seems unduly conservative since under the standardized approach instruments with a three-year average cumulative default probability of 11.68 percent could have a 100 percent risk weighting.

The New Accord includes proposed risk weights for retail exposures, but states that *"The risk weights presented below should be seen as illustrative or indicative and should not be viewed in the same manner as those described above for corporate exposures."* These risk weights seem to follow the same derivation and methodology as those for corporate claims, but no information is given as to the specific asset correlation or confidence level used to derive them. A 99.5 percent confidence level and asset correlation of 8 percent produces risk weights very close to those in the New Accord, but it would be easier to judge if these weights are appropriate for retail exposures if actual parameters were revealed. The Department questions the usefulness of publishing risk weights that the Committee describes as tentative.

- **Elaborate on IRB approach to project finance.**

The New Accord lumps raw land loans, construction loans, commercial real estate loans, energy loans, natural resources loans, mining loans, power loans, transportation infrastructure loans, environment loans, media loans, and telecommunication loans under the project finance label. While these loans have some common characteristics, they differ significantly in risk and loss experiences. No bank would be able to estimate an appropriate PD, loss given default (LGD), and exposure at default (EAD) for such diverse credits. The Committee should approach these areas based on the distinct experiences and risks of their separate industries.

- **Eliminate the restriction that capital requirements for credit risk for the first two years of the advanced IRB approach be no less than ninety percent of that calculated under the foundation IRB approach.**

Banks that meet the extensive and demanding criteria detailed in the consultative document for the advanced IRB approach should not be limited to a ten percent capital savings for two years. This requirement and corresponding cost to follow both IRB approaches may discourage some banks from even attempting to meet the standards required for the advanced IRB approach. The Department also suggests that the Committee revisit the minimum requirements for the advanced IRB approach

if few banks meet such requirements. Supervisors should encourage complex banks to adopt the advanced IRB approach. Supervisors, of course, will retain the ability to terminate the advanced IRB approach at any time.

- **Revise required disclosures and consider pre-commitment approach.**

The market discipline pillar forces banks to disclose proprietary information. This will put banks at a competitive disadvantage against their non-bank competitors. The disclosures cover not only loans and loan commitments but securities, including over the counter derivatives and presumably venture capital activities. The level of disclosure drills down to where the financial statement reader can compare the LGD estimated by a credit model for a given risk bucket to what actual experience has been. Such extensive disclosures also raise cost issues.

The pre-commitment approach may represent a viable alternative. For example, if credit disclosures as envisioned by the New Accord were made quarterly to regulators, the pre-commitment approach could be used to monitor capital. This would avoid the competitive and proprietary problems raised by the New Accord.

Please feel free to contact John McEnerney, Chief of Regulatory Accounting, at (212) 618-6953 or john.mcenerney@banking.state.ny.us if you would like to discuss our views.

Very truly yours,

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