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

Re: Overview of The New Capital Accord
Third Consultative Document (CP3)

Ladies and Gentlemen:

Bank One Corporation appreciates the opportunity to comment on the Basel Committee's third consultative document - "Overview of The New Basel Capital Accord" ("the Accord"). Bank One is a multi-bank holding company with managed assets in excess of \$335 billion as of June 30, 2003, with business activities covering the full spectrum of retail and commercial financial services.

We support the risk-based capital principles contained in the Accord and commend the Basel Committee for developing a practical framework for their implementation. We endorse the objective of creating a framework that accurately differentiates risk, moves the industry to more advanced risk management practices, and establishes a level playing field across the financial services industry. As currently drafted, Bank One's primary concerns about the proposed framework relate to risk measurement of retail assets and certain securitization activities. We also believe the cumulative effect of conservatism within the Accord and the prescriptive nature of its implementation may ultimately result in capital requirements significantly higher than the minimum standard intended by Pillar I.

Our response highlights specific areas within the Accord that differ from industry best practice and offers practical alternatives without sacrificing the spirit of the Accord.

Retail Exposure

As one of the largest participant in the U.S. retail banking and credit card markets, Bank One has followed closely the Committee's work in formulating the retail framework. While we appreciate the Committee's progress in responding to our original concerns, some issues remain unresolved.

Framework: The rules covering retail assets are derived largely from the proposed commercial framework and are not consistent with industry risk management practice. The Accord requires estimates of probability of default (PD) and loss given default (LGD) independently, while the industry measures and manages exposure based on expected loss (EL) alone.

While a PD / LGD foundation is sound for commercial assets where severity is observable on a transaction-by-transaction basis, the framework is not practical for retail assets. Retail assets typically are managed on a pool basis where there is often a high correlation between the value of the underlying collateral and a borrower's probability of default, making it difficult to separate objectively losses into the components of frequency and severity. The industry measures and manages risk on a portfolio loss basis and the volatility around it.

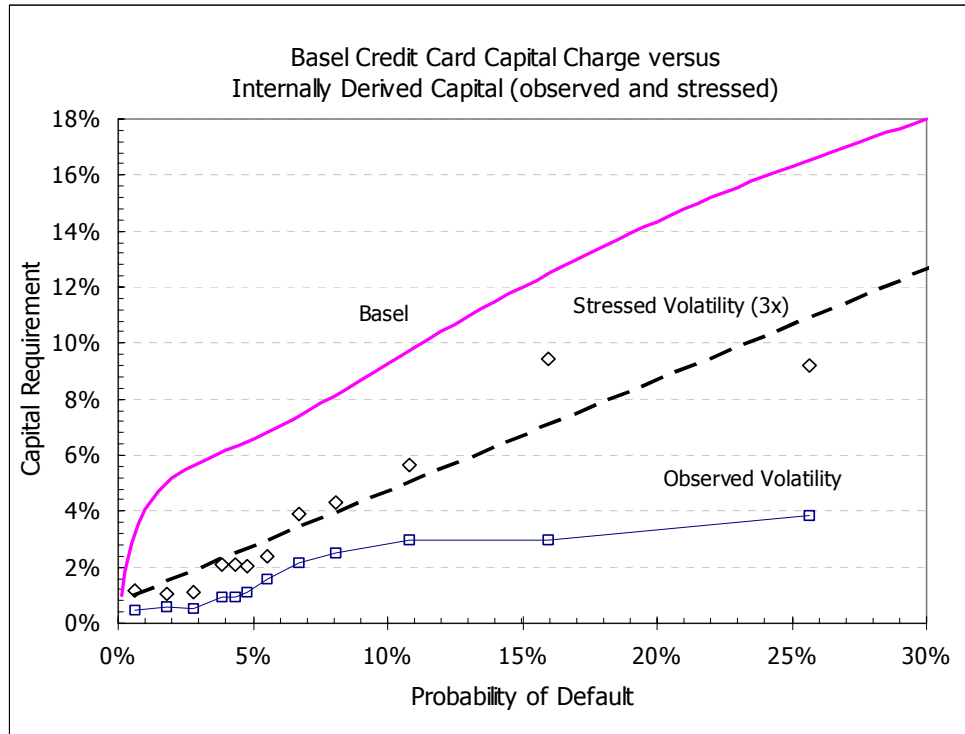
As currently written, the PD / LGD framework provides a potential capital arbitrage based on a firm's definition of default. Since EL is the product of PD and LGD, various combinations of the two parameters are possible for the same EL. The capital requirement for each combination is different, implying volatility around PD and LGD behave differently. While this may be true, analysis to separate PD and LGD behavior can be quite subjective, would be a significant implementation burden and adds little value to current practice.

Calibration of Retail Risk Weight Function: While we understand the Committee's desire to limit the number of different risk weight curves, we believe the complexity of retail risk distilled to only three curves will create inaccurate capital requirements for a significant subset of products. Alternatively, using EL and asset correlation as inputs to a single risk weight function would provide more accurate capital requirements due to the finer risk sensitivity of asset correlation.

The following two examples illustrate our calibration concerns:

Prime Credit Card Assets - The loss volatility in our prime credit card portfolio data is too low to support the level of capital resulting under the Accord. This is particularly true for low PD revolving retail asset, which covers the majority of our exposure. Our credit card portfolio data stressed to three times its observed volatility fails to produce economic capital factors as high as that implied by the Basel risk weight function. Quantifying the difference, we observe that prime

credit card assets with a PD less than five percent require economic capital in the one to three percent range using trebled Bank One loss volatility. The Basel risk weight function applied to the same credit card assets results in capital requirements of more than five percent. The chart below illustrates the difference between the two capital requirements (economic capital requirements based on one times Bank One loss volatility are shown as well).



This discrepancy is due to the relationship between PD and correlation embedded in the Basel function. Analysis of our retail and commercial data has not produced the clear inverse relationship between PD and correlation that the risk weight formulas suggest and does not support the dramatic increase in correlation as PD declines.

Second Lien Home Equity Loans - The residential mortgage curve is calibrated for traditional first mortgages rather than high loan-to-value second mortgages or home equity loans. Given the higher loss severity on these loans relative to traditional first mortgages, the mortgage risk weight function produces unusually high capital requirements. As a result, the capital requirement for a high LTV second mortgage is greater than it is for an unsecured credit card loan to the same borrower.

As LGD approaches 100% for high LTV second mortgages, the loan becomes unsecured. Analysis of internal data demonstrates that borrowers in the extreme circumstance of abandoning their residence rarely continue to pay their credit card bill. In other words, a mortgage is not subordinate to a credit card. As LTV increases and collateral protection goes away, capital requirements for a second mortgage should approach but never exceed the capital requirement for an unsecured credit card loan to the same borrower.

The mortgage risk weight function uses a constant 15% correlation across PD to capture the influence of housing values on losses. High LTV mortgages, particularly second mortgages with very little collateral protection, are much less susceptible to changes in the underlying housing value than traditional first mortgages. In addition to the correlation assumption, the capital discrepancy also reflects the FMI credit provided to revolving assets but not to mortgage loans (see following section).

Definition of Capital and Recognition of Future Margin Income: Bank One believes that the inclusion of expected loss in the Committee's definition of capital is inconsistent with industry practice. We acknowledge that the Committee has provided offsets through the limited recognition of future margin income (FMI) for revolving retail assets and the recognition of all general reserves (even those excluded under the current definition of capital).

If expected losses are to remain in the definition of capital, the Accord should allow FMI as an offset for all retail assets and perhaps certain commercial exposures. Most transactions are priced to cover EL and some capital charge. In any transaction where margin at the pool or portfolio level exists to offset expected losses, that cashflow should be recognized as the first defense against losses and reduce the regulatory capital requirement.

In addition, the proposal is overly conservative on recognition of FMI, which must exceed EL by at least two standard deviations to receive maximum credit. Even when FMI exceeds EL with this degree of certainty, the proposal only allows capital reduction equal to 75% of EL. We understand the need in some circumstances to haircut the amount of FMI benefit recognized, but believe the haircut should be 'phased in' as the certainty of FMI coverage decreases.

Securitization

There are several areas in the Accord where capital requirements do not reflect the way a securitization transaction redistributes risk. Our concerns center on securitization of purchased receivables and revolving asset securitizations.

Rating Net Exposure for CP Conduit: The Accord requires evaluation of asset pools held in conduits based on their gross risk exposure prior to the recognition of any credit enhancement. Credit enhancement is then recognized through the application of the supervisory formula. Rating agencies directly reflect in their rating the level of credit enhancement provided by over-collateralization and other structural components. As most banks measure risk in a manner consistent with rating agency methods, capital should be derived through a similar approach. This would avoid creating a redundant process solely for regulatory capital purposes that, when properly calibrated, will produce substantially the same results. Internal models leverage the rating agencies' independent evaluation of these risks based on their long history of monitoring the credit performance of similar transactions.

Supervisory Formula and Minimum Risk Weight: Under the supervisory formula, most conduit assets and many other unrated security tranches receive a capital charge of 56 basis points based on a seven percent minimum risk weight. The floor is based on risk weights derived from the Peretyatkin / Perraudin study on Capital for Asset-Backed Securities*. The study assumes losses in retail portfolios are 60% correlated to a bank's loan portfolio, although Moody's retail default rates shows correlation of no more than 30% to the Fed's bank loan default history. This lower correlation assumption would decrease the capital charge by more than 50%.

Dilution Risk for Purchased Receivables: Trade receivable dilution occurs over the normal course of business as a result of damages, discounts or returns. As dilution can be material in trade or credit card receivables, recourse is normally built into the structure of securities backed by these assets. The Accord does not recognize recourse to the seller for capital purposes and requires dollar for dollar capital for any expected dilution above specific reserves. This overstates capital requirements and is inconsistent with rating agency and industry practice where dilution risk is treated as unsecured exposure to the seller. Again, we would prefer regulatory capital treatment consistent with industry practice, especially when alternative treatment produces incorrect results.

Program Wide Credit Enhancement: Program wide credit enhancement provides umbrella coverage to multiple securitizations and 'overlaps' coverage provided by deal specific liquidity facilities. We agree in principal with the Committee's treatment of overlapping credit enhancement, under which capital requirements are calculated independently for each overlapping piece. To avoid double counting exposure, the combined capital requirement is set equal to the higher requirement of the individual overlapping pieces. It would be more accurate to measure the capital requirement for the program wide credit enhancement against the weighted average risk of all assets covered under the protection, rather than on the worst rated asset as proposed. Using the rating of the worst quality asset leads to a large overstatement of capital requirements for some

* Capital for Asset-Backed Securities, February 2003 by Vladislav Peretyatkin and William Perraudin. A paper prepared for the Securitisation Sub-Group of the Basel Committee

umbrella coverage. Improper risk assessment for program wide credit enhancement could discourage banks from investing in this mitigation tool.

Risk Transference on Revolving Securitization: Previously we noted that the risk weight function for credit card assets produces capital requirements too high for the given risk. At the same time, we believe the proposal to provide capital relief for credit card securitizations understates the risk retained by the originating firm. While the effect of the two may offset, individually they may drive non-economic decisions.

The treatment of revolving securitizations is inconsistent with the Committee's stated objective of providing capital relief only when meaningful risk transference occurs. This form of securitization functions primarily as a financing vehicle that, which utilizes structural mechanisms to insulate the investor from the credit risk of the receivables in all but catastrophic events. The proposed framework for revolving structures creates a 'cliff effect' requiring increased capital as spread income deteriorates on the securitized pool of assets. This is the only place in Basel where capital is required as the capital event approaches and forces originators to raise capital when it becomes too expensive or is the least available.

Cumulative Effect of Conservatism

There are numerous instances of minimums and limits that introduce a degree of conservatism to the capital calculation under Pillar I. These include limited recognition of FMI, limited recognition of risk mitigation tools, limited recognition of collateral on certain loans, and minimum risk weights for certain assets. We believe that artificial floors and minimums are inconsistent with the Committee's desire to create a framework intended to represent a minimum capital standard and to provide better risk-differentiation. While we understand the Committee's objective of maintaining the current aggregate level of capital across the industry, it should establish a framework that rewards firms that have materially less risky balance sheets.

Pillar I is intended to represent a true minimum capital standard governed by Pillars II and III, which function to motivate firms to an appropriate level of capitalization. The Committee has chosen a 99.9% confidence level for establishing minimum capital requirements. This confidence level suggests a single 'A' solvency standard made even higher by the inclusion of conservative biases noted. As some firms already choose to operate at a lower solvency standard, Pillar I requirements should represent the lowest solvency standard tolerable for regulated firms. Most banks will choose to operate above that standard, realizing the commensurate level of improved debt cost and market access. Market discipline will provide the necessary impetus to drive banks to an optimal capitalization level.

Conclusion

Bank One appreciates the willingness of the Committee and all supervisory agencies to engage in a constructive dialogue with the industry as we move towards consensus on the final form of the Accord. As detailed in CP3, the Basel II Capital Accord represents significant progress toward the common goal of establishing a more robust risk-based capital standard for the financial services industry. The Committee is to be commended for setting forth a framework that balances the complexities of quantifying the risk exposures involved with the practical limitations of a broad-based implementation.

Our primary concerns center around the details of the retail framework and the treatment of securitizations. We are optimistic that these issues can be resolved to the satisfaction of all concerned.

Respectfully,

/s/ Heidi Miller
Heidi Miller
Executive Vice President and
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