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

Mr. Richard Spillenkothen
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Board of Governors of the Federal Reserve System
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Dear Mrs. Nouy and Mr. Spillenkothen:

The New York State Banking Department ("the Department") appreciates the opportunity to comment on this Third Consultative Document of the New Basel Capital Accord (Basel II), and is grateful for the immense effort on the part of the Committee that produced this document. The last four years have been extremely productive in terms of risk modeling, risk management, and dialogue between supervisors and bankers because of the Committee's work. The Department hopes that national supervisors will pursue the development of implementation guidelines for Basel II, in the same spirit as the Committee's efforts. Information sharing, research, and discussion among supervisors is essential for consistent application of the New Accord across supervisory jurisdictions.

However, implementing Basel II will be a highly complex operation both for banks following the Advanced approaches and their supervisors. The Department is concerned that the level of technical expertise demanded by the authors of the New Accord will make informed senior management oversight difficult to achieve. Simplifying the complexity of Basel II would also reduce the burden on supervisors and result in more understandable regulation.

The Department proposes that the three years 2006 through 2008 – including the two years that floors will be in place – should be devoted to study by supervisors of the impact of these new capital regulations on the banking industry and on the market for bank products. The Department believes that it is essential supervisors reach agreement on "best practices" for implementation of the New Basel Capital Accord – that guidelines be agreed upon that allow supervisors to apply the requirements in a uniform manner across banks. The Department plans, with finalization of the New Basel Capital Accord, to institute programs to study implementation of the New Accord. It is only through sharing of information, coordination of implementation programs, and through discussions between supervisors that supervisory best practices will emerge.

I. Pillar 1: Transition Period, 2006 – 2008

The Committee has instituted capital floors for banks adopting either of the Internal Ratings Based Approaches for two years following implementation at year end 2006. These floors – 90% in 2007 and 80% in 2008 – are based on Basel I calculations of capital. The Committee states: "Should problems emerge during this period, the Committee will seek to take appropriate measures to address them, and, in particular, will be prepared to keep the floor in place beyond 2008 if necessary." The Department suggests that there are a number of areas where possible consequences of the new regulation need to be watched and observed. The Department recommends that the Committee institute a formal process to track changes due to the New Basel Capital Accord. Of particular importance are the level of capital after implementation of Basel II, the effects of new risk weights, and variations in parameter estimation.

Level of Capital

The most recent Quantitative Impact Survey carried out by the Basel Committee (QIS 3) indicates that it is likely that the amount of capital required for credit risk will be lower once the New Capital Accord is implemented. QIS 3 reported average changes in the capital requirement for credit risk that ranged from 0% for large internationally active banks under the Standardized approach to -13% for these banks under the Advanced IRB approach. Smaller, often more specialized, banks had changes in required capital of -11% under the Standardized approach and -26% under the Foundation IRB approach.[1] Relevant to this discussion are studies the Department carried out on the possible effect of instituting the Standardized approach for New York banks with assets between $1 billion and $40 billion. The Department found an average change of -7% in estimated required capital for credit risk for a group of New York banks, assuming the most recent revisions to the New Basel Accord.

Any decrease in required capital for credit risk will be accompanied by a new charge for operational risk. Here, however, the QIS 3 data are less helpful as banks participating in the survey followed either the Basic Indicator or Standardized approaches in calculating operational risk capital requirements. It is most likely that the operational risk charges will be lower for banks following the Advanced Measurement Approach – however, an AMA system is expensive, with extensive infrastructure requirements. For the banks that do not choose to follow the AMA, the operational risk charge will be based on gross income – a poor proxy, in the Department's opinion, for operational risk. It is also likely that this charge will vary widely from bank to bank – as the relationship of gross income to risk-weighted assets varies widely from bank to bank. Thus, the level of capital may experience a downward trend, mitigated somewhat by an uneven operational risk element.

Effects of New Risk Weights on Bank Portfolios

It is possible that the relatively lighter risk weights for retail portfolios – both residential real estate and loans to individuals – will have the effect of discouraging banks from holding assets in certain other categories, e.g., commercial loans, as the amount of capital required for retail portfolios may be less. Similarly, non-retail loans may be priced higher, to reflect the relatively

[1] " Supplementary Information on QIS3," Basel Committee on Banking Supervision, May 27, 2003.

greater amount of capital required. This is particularly worrisome for loans to unrated companies, where a paucity of market data for the obligors may lead to more difficult modeling. The Department recommends that the Committee (or perhaps a consortium of supervisors) study the effect, if any, on the relative availability of credit for commercial and retail customers during the two years floors are in effect, with the option of re-calibrating before the end of this period.

Variations in Parameter Estimation

According to "Supplementary Information on QIS 3," the average PD (probability of default) for corporate exposures for participating banks ranged from 0% to almost 7%, with the majority of the average PDs below 2%, and about half of these under 1%. The average corporate LGD (loss given default) for Advanced IRB banks in the QIS ranged from about 5% to almost 60%. Both of these parameters show wide variation; it is most likely that this variation is due in part to differences in parameter estimation methodology. It is important that differences in parameter estimation be studied and analyzed to allow supervisors to apply the IRB qualifying requirements consistently. Reviewing parameter estimation methodologies up to and during the transition period may also yield insights about the effect of economic cycles on these methodologies.

II. Pillar 2

The importance of supervisory review has been enhanced in CP-3, as inadequacies of an internal ratings based approach have added items for supervisory oversight.

- The IRB model for calculation of required credit risk capital delivers portfolio invariant requirements only if one assumes infinitely fine-grained portfolios. A granularity adjustment, based on the number of obligors, was introduced in CP-2 in January 2001. This Pillar 1 adjustment would effectively produce heavier risk weights for portfolios with obligor concentrations. However, the granularity adjustment is no longer part of the IRB approach, and credit concentration risk is covered under the supervisory review process. The Department suggests that supervisors develop standards of diversification for bank portfolios, and consider either restricting access to the IRB approach to banks with diversified portfolios or applying a granularity adjustment for concentrated and un-diversified portfolios.
- Models do not always address the unique features of structured finance deals since many of them are one-off transactions. However, provided there is sufficient data sharing between regulatory agencies, supervisors will be able to view these deals in context across the banking industry. Thus, corporate governance and supervisory review are essential to mitigate the silo effect of Pillar 1's focus on individual institutions.
- The qualifying requirements for the Advanced IRB approach include the following statements (italics added) which will require interpretation by supervisors under Pillar 2:
    - A bank must have a *meaningful* distribution of exposures across grades with no *excessive* concentrations.
    - The model must be *accurate on average* across the range of borrowers or facilities to which the bank is exposed.
    - The rating definitions and criteria must be both *plausible* and *intuitive* and must result in a *meaningful* differentiation of risk.

- Banks must have well-articulated internal standards for situations where deviations in realized PDs, LGDs, and EADs from expectations become *significant enough* to call the validity of the estimates into question. These standards must take account of business cycles and similar systematic variability in default experiences. Where realized values continue to be *higher than expected* values, banks must revise estimates *upward* to reflect their default and loss experience.

- These requirements can be applied in ways different enough to allow varied risk weights for the same exposure. It is essential that supervisors reach agreement on guidelines for implementation of the New Accord. In light of the continuing development of internal models, the scarcity of data, and the profiles which lead to customized models, supervisors face a real challenge in finding fair and consistent methods for carrying out the necessary approval and review processes. The requirement under Pillar 2 that "Supervisors must take care to carry out their obligations in a highly transparent and accountable manner" underscores this challenge.
- Capital is not a substitute for a weak internal control environment or risk management system. Supervisors are responsible for review of board and senior management oversight, the soundness of the bank's capital assessment and assessment of risks, the bank's risk monitoring and reporting, and internal controls.

III. Pillar 3

- There are indications that corporate governance will continue to improve as high-profile bankruptcy cases remain in the public eye, but it is not clear how long this institutional knowledge will be remembered. Divergent national accounting standards and the varying amounts of company disclosure in different countries limit the effectiveness of Pillar 3.
- According to CP-3, "Under Pillar 1, banks use specified approaches/methodologies for measuring the various risks they face and the resulting capital requirements. The Committee believes that providing disclosures that are based on this common framework is an effective means of informing the market about a bank's exposure to those risks and provides a consistent and understandable disclosure framework that enhances comparability." However, unless there is agreement among supervisors on application of the requirements, there will be relatively little comparability between banks' disclosures. Lack of comparability among disclosures could lead to less transparency and the possibility of obfuscation of information.
- Per paragraph 763, "Management should use its discretion in determining the appropriate medium and location of the disclosure." This invites management to put required disclosures in obscure places, thereby greatly reducing this pillar's value. The Committee should instead describe acceptable venues for disclosures and direct that they be easily accessible to the public.
- Pillar 3 disclosures should be audited by an external auditor to provide the market with greater comfort in the reasonableness of the disclosures.
- Supervisors should periodically sample banks' reporting under Pillar 3 and promote consistency in presentation among market participants to better permit peer comparisons. Additionally, most, if not all, of the quantitative measures should build up to a minimum five-year presentation of data. It appears now that only one year of information is required.

IV. Credit Risk Issues

Definition of Default

The Basel Committee has stated a reference definition of default in CP-3 that differs from both external rating agency definitions and from some banks' definitions. If banks use data that are not consistent with this definition, then they must make adjustments to "achieve broad equivalence with the reference definition." CP-3 also states that national supervisors will provide appropriate guidance as to how the elements the Committee describes as "indications of unlikeliness to pay" must be implemented and monitored. The Department recommends that the Committee publish guidelines for determining when the sale of a credit obligation is at a "material credit-related economic loss" to further agreement across jurisdictions. The Department suggests that the Committee consider the distressed loan market definition of sale at ninety cents on the dollar or less as a material economic loss.

Netting Arrangements

The Committee should expand netting beyond loans and deposits to other assets and liabilities when the defined criteria are met. This will give banks an additional incentive to reduce their exposures and enhance risk management. A similar positive process occurred for U.S. banks when accounting standards changed to permit netting of receivables and payables resulting from derivative instruments subject to master netting arrangements.

Equity Capital Charges

The capital requirement for credit risk related to equities (particularly in the PD/LGD approach under long-term relationships) appears inconsistent with deeply subordinated investment grade or noninvestment grade fixed income capital charges. Rationalization should occur between these categories, and with haircuts for equity collateral. As currently drafted, participants with significant equity holdings may have a competitive capital advantage over a lender holding debt with equity characteristics.

Standardized Approach for Credit Risk

The Department recommends that the number of internal ratings buckets should be expanded, since BB credits (non-investment grade), which have higher default and loss rates, are bucketed with BBB (investment grade) credits.

IRB Approach for Credit Risk

Although the Committee did create several asset classes with subclasses, the Department feels that the number of risk weight curves is still too limited, and that an industry approach to corporates would be more meaningful than the general corporate, SME, and specialized lending categories. While specialized lending exposures have some common characteristics, they differ substantially in terms of underwriting criteria by industry.

V. Operational Risk Capital Charge

Basic Indicator and Standardized Approaches

The Committee's continued use of gross income as the key measure for both the Basic Indicator and the Standardized Approaches can best be described as ill-advised, for the reasons detailed in the Department's April 10, 2000, May 31, 2001, and November 1, 2001, letters to the Committee. Most notably, a huge loss due to operational problems could result in a lower capital requirement for operational risk. Also, simply using gross income as a proxy for operational risk seems out of character with the treatment of asset risks. Falling revenue, which would call for less capital, could actually be a reflection of poor business practices, increased errors, or reputational problems.

While the Alternative Standardized Approach represents an improvement over the Basic Indicator and Standardized approaches, it is equally crude in not being linked to internal controls. These approaches, coupled with the Committee's insistence on establishing a minimum capital requirement for operational risk, weaken the New Accord. If the Committee is unable to provide a more meaningful benchmark such as internal control ratings, then the Department urges the Committee to abandon these two approaches.

Advanced Measurement Approach

The Department applauds the Committee's proposal to allow banks to use their own methods for assessing their exposure to operational risk under AMA. However, the lack of a regulatory model for the Advanced Measurement Approach for operational risk makes this capital requirement open to much more variation than the A-IRB credit risk charge. Banks with similar business portfolios may have very different capital requirements because of differences in modeling. Insofar as banks' operational risk models reflect the control environment, one would expect differences in capital calculations. However, there may be more serious differences that come from modeling methodology, which could overwhelm control environment and business profile differences.

Modeling differences may be aggravated by the requirement to use external data for extreme events. The Department supports the ongoing modeling efforts being carried out by banks and supervisors. However, there are no minimums and no quantitative benchmarks for operational risk under the AMA. This becomes problematic in the case of risks that most market participants are unable to quantify (e.g., losses from terrorism). Considering the difficulty of combining low frequency/high severity operational risk and high frequency/low severity operational risk in one model, the Department suggests that the Committee consider developing a supervisory formula for low frequency/high severity events, based on a bank's risk profile. An agreed-upon capital requirement for these hard-to-quantify risks would promote transparency and consistency.

Recognition of Insurance

Insurance should be allowed to mitigate the operational risk capital charge regardless of the measurement approach being used. It seems particularly important to recognize the mitigating effects of insurance for the Basic Indicator and Standardized Approach banks since the methodology for calculating operational risk is so much cruder under these approaches than in the AMA.

External Events

The definition of operational risk includes "risk of loss from external events." Clearly, there are some extreme external events, e.g., natural disasters or acts of terrorism, over which management has no influence. Nor can management ever be sure how much capital is necessary to protect the institution from losses due to these extreme external events. Recently, the financial sector was impacted by the September 11th terrorist attacks. The sector's recovery from these terrible attacks was accomplished through the existence of contingency plans and backup sites, the cooperation and support of all market participants, including the Federal Reserve and other regulatory agencies, and the possession of insurance policies. It is not clear what role capital played in the banks' recovery.

The Department suggests that the limit to 20% of insurance as an offset of operational risk capital requirements may be too low and should be re-evaluated to allow banks to recognize coverage for extreme external events. According to the 2002 Loss Data Collection Exercise for Operational Risk,[2] the event type "damage to physical assets," which included the losses from the September 11th terrorist attacks, showed the greatest percentage of insurance claims. Insurance claims were filed for 34% or 220 loss events in this category; 88% of these claims resulted in a recovery of some amount. Similarly, this event category showed the greatest monetary recovery across all business lines; there were recoveries for 58% of the monetary amount of losses in this event category.

The Department is in favor of banks collecting and maintaining data on the losses from all external events, as this information is crucial to contingency planning, and recommends that damage from extreme external events be distinguished from damage due to other events. However, the Department suggests that capital requirements are most effective when applied to risks susceptible to management's influence. Further, the Department recommends that existence of detailed contingency plans for business disruptions be considered a mitigant for operational risk due to extreme external events.

VI. A Level Playing Field

The New York State Banking Department supervises large internationally active banks, domestic banks, branches and agencies of foreign banks, and investment companies. In addition, 13 of the domestic banks chartered by New York State are subsidiaries of foreign banking groups. New York State – chartered institutions compete with both foreign and domestic banks as well as foreign and domestic non-bank financial institutions. Level playing fields in all these arenas are important to the institutions the Department supervises. The Department is concerned that competitive imbalances in implementation of the New Basel Accord may arise as a result of the following:

- Actual implementation may vary significantly from country to country because of the many "Areas of National Discretion" in CP-3. Among items left to the discretion of national supervisors are:
  - Identification of short-term exposures exempt from maturity floors
  - The appropriateness of using 180 days past due rather than 90 days past due in the definition of default

[2] "The 2002 Loss Data Collection Exercise for Operational Risk: Summary of the Data Collected," Risk Management Group, Basel Committee for Banking Supervision, March 2003.

- Assignment of commercial real estate exposures to the high-volatility commercial real estate category
- Venue of publication of disclosure statements

- There are differences in accounting and reporting standards (for example, treatment of provisions) from country to country that will again make it difficult to implement the New Accord uniformly across countries.
- Many elements of the requirements for adoption of the Internal Ratings Based Approach and the Advanced Measurement Approach are open to different interpretations.

Agreement and interaction among supervisors is essential to minimize these possible differences in implementation, and to forestall arbitrage of regulatory regimes.

Please feel free to contact Katherine Wyatt at (212) 709-1538 or katherine.wyatt@banking.state.ny.us if you would like to discuss our views.

Very truly yours,

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