

April 16, 2010

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

Delivered via e-mail to [baselcommittee@bis.org](mailto:baselcommittee@bis.org)

RE: Response to consultative document, "*Strengthening the resilience of the banking sector*"

Ladies and Gentlemen:

Thank you for providing The Risk Management Association (RMA) the opportunity to comment on the Basel Committee on Banking Supervision's consultative document "Strengthening the resilience of the banking sector" (BCBS 164) published in December 2009. RMA, a member-driven professional association, helps banking and nonbanking institutions identify and manage the effects of credit risk, operational risk, and market risk on their businesses and customers. The Capital Working Group of RMA prepared this response; the Group has been providing independent analysis on matters pertaining to risk and capital regulation since its inception in 1999.

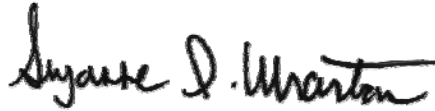
- We agree that the issues addressed by this Consultative Document are of the utmost importance in returning the world's largest banks to positions of well-capitalized soundness, to increase their combined ability to weather another crisis, and to reduce the probability of a recurrence of a similar crisis. Despite the general agreement with the objectives of Basel, we present our most pressing concerns with regard to the implementation of the new standards in the attached response letter. We are especially concerned about the following issues, although the order of importance will vary depending on the particular business activities of our members:
- The proposed leverage ratio will likely have the opposite effect of that intended; it will drive banks out of low-risk credit activities for which the rate of return on the arbitrary capital requirement will be insufficient.
- The list of deductions from capital include certain assets that have clearly defined values and secondary markets, such as mortgage servicing rights and deferred tax assets. Such deductions are inappropriate and can induce behavior that runs counter to improving bank soundness.
- The proposed treatment of the Allowance for Loan and Lease Losses will have significant cross-border competitive equity effects that must carefully be considered in structuring the final rule.
- The proposal to adopt a 1250% risk weight for certain positions that previously have been deducted 50/50 from Tier 1 and Tier 2 capital, results in effective capital allocations that are all out of proportion to risk. These effective capital requirements are complicated by supervisory requirements in the U.S. that lead to effective capital ratio requirements above the Basel II minimums. When the 1250% risk weight is used, instead of the 50/50 deduction, the resulting supervisory requirements can easily result in a total capital requirement above 100% and, sometimes, a Tier 1 capital requirement above 100%.
- We agree with the need for capital buffers above the regulatory minimums. However, we believe that such buffers should be a Pillar 2 issue and confidential in nature. Hard-wired Pillar 1 capital buffers will only serve to raise the true capital minimums and banks would have to hold a buffer above such a buffer.
- We also believe that pro-cyclicality should be reduced, but specific proposals within the Consultative Document may not succeed in achieving such reduction, or may do so at a cost of reducing prudent lending. We discuss other methods that might work as intended.

Please feel free to contact Ed DeMarco via email at [edemarco@rmahq.org](mailto:edemarco@rmahq.org) or Sue Wharton via email at [swharton@rmahq.org](mailto:swharton@rmahq.org).

Sincerely yours,

A handwritten signature in black ink, appearing to read "Edward J. DeMarco", with a long horizontal flourish extending to the right.

Edward J. DeMarco  
General Counsel

A handwritten signature in black ink, appearing to read "Suzanne I. Wharton", with a long horizontal flourish extending to the right.

Suzanne I. Wharton  
Associate Director, Enterprise Risk

cc: Federal Reserve Board; Comptroller of the Currency; Federal Deposit Insurance Corporation (by e-mail).

## **Response to BCBS 164 -- Strengthening the resilience of the banking sector**

April 16, 2010

### **I. Introduction and overview of major issues.**

The RMA Capital Working Group appreciates this opportunity to comment on the December, 2009 Consultative Document dealing with new definitions of capital, a new leverage ratio capital requirement, a new Common Equity to risk-weighted-assets ratio requirement, and other measures to strengthen banking institutions in Basel countries. The Capital Working Group consists of senior staff at major banking companies responsible for risk measurement and management, including the management of bank capital positions.<sup>1</sup> The long-held view of the Group is that capital requirements should always, as accurately as possible, reflect the risk associated with bank exposures. Capital requirements that are not accurately risk-based can harm bank soundness, and we discuss this and related issues at length below.

The Group agrees that the issues being addressed by this Consultative Document are of the utmost importance in returning the world's largest banks to positions of well-capitalized soundness and to increase their combined ability to weather another crisis as well as to reduce the probability of a similar crisis again occurring. In this regard, it is most important, in our view, that the Basel Committee focus on the significant differences across Basel countries pertaining to accounting treatments and tax treatments of the loan-loss reserving process, the accounting treatment of securitization sponsorship, and the historical use of terminology such as intangibles when referring to balance-sheet items that determine the level of actual capital being held by any institution. The Consultative Document has been careful to address these significant cross-border differences, and we applaud the Committee's sensitivity on these issues.

In this response, we do not address the Consultative Document's treatment of counterparty credit risk and certain other matters affecting the trading desks of the major financial institutions. Rather, most of our Group's members are also members of ISDA and we support fully the response being submitted by ISDA.

Below, we present our most pressing concerns with regard to the implementation of the new standards, while at the same time agreeing, in general, with the Committee's desire to define capital more narrowly and more effectively so as to improve, over the longer run, the strength and usefulness of bank capital.

#### **A. The new leverage ratio requirement.**

Our general view is that any leverage ratio requirement works at odds with a well-structured risk-based capital requirement. Effectively, any leverage ratio minimum for a low-risk activity -- an activity for which a best-practice estimate of risk capital is lower than the leverage ratio minimum -- will induce banks to exit that low-risk activity and/or seek high-risk activities for which the best-practice estimate of risk capital is higher than the leverage-ratio requirement. This shifting of activities toward higher-risk activities as the result of a leverage ratio minimum was experienced in

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<sup>1</sup> An appendix list the names of institutions and staff that assisted in the preparation of this response. Individual institutions may disagree with specific points made in this response and/or may be providing a separate response to the Consultative Document.

the U.S. both during the last commercial credit crisis during the late 1980's and early 1990's, and during the run-up to the current crisis.

A leverage ratio requirement, at best, has a psychological benefit in that it is viewed by some as a fail-safe mechanism in cases where the risk-based capital requirement is too low. A more desirable process, however, from the point of view of improving bank soundness, is to fix existing problems with the risk-based capital allocation structure. Thus, we applaud the Committee's recent efforts to improve risk-based capital for various off-balance-sheet activities including securitization activities. But any attempt to supplement these new risk-based measures with a simple non-risk-based leverage ratio will only serve to drive banks into those activities that have sufficiently high yields to justify the leverage ratio requirement, whenever that leverage ratio is the binding requirement for that particular kind of activity. By binding we mean whenever the leverage ratio requirement is above the risk-based regulatory capital requirement for an activity or above a best-practice measurement of appropriate capital to be held against the activity. We give a specific example of such effects below.

Given the current political climate, however, we understand that Basel may have to implement a leverage ratio requirement, despite its obvious shortcomings. If this is the case, we respectfully suggest that such a leverage ratio requirement have the following properties:

1. Have more than one bucket, for purposes of the leverage ratio, into which to put various risk activities. For example,
  - a. Assign a low or zero leverage ratio to safe, highly liquid assets that the bank will be using to meet the new liquidity ratio requirements.
  - b. Assign a lower leverage ratio requirement to traditional, low-risk lending than to much riskier forms of activity for which there is concern that even the new risk-based capital allocations might be somehow gamed or simply set too low.
2. Allow for the use of risk-mitigation efforts by the bank to reduce the exposure level to which the leverage ratio would apply. Allowing single-name netting, for example, would provide proper incentive to manage a book of derivative positions properly in order to lower overall risk.
3. Use a regulatory estimate of exposure for off-balance-sheet activities rather than a notional amount that could greatly overestimate risk or, more importantly, could treat different levels of risk as if they were equally risky.
  - a. Use a regulatory measure of exposure for unused lines and other binding commitments.
  - b. Use a regulatory measure of exposure for derivative positions.
4. Take care to set the leverage ratio requirement for any large bucket of activity so that it is not binding during normal times with respect to significant low risk activities in that bucket.

To fully understand the deleterious effects of a leverage ratio, consider the following example: A bank is considering making a short term loan to a highly-rated corporation. Assume that the risk-based capital requirement for the loan implies a 10% risk-weight, so the Tier 1 true capital requirement is only 0.4% of the asset.<sup>2</sup> Assume that the market place typically assigns this type of loan a 20bp spread over Libor, net of non-interest expenses. Further, assume the bank's internal capital allocation system for Basel ICAAP purposes indicates that real capital in the amount of 1.2% should be held against the asset. In this example, the risk-based capital charge is not binding and the resulting rate of return on capital for the bank would be 16.67% -- an acceptable rate of return on capital in this depressed economy.

Conversely, consider the implications of a 3% leverage ratio minimum that is required by regulators. The asset now earns a ROE of 6.67% and the bank must look for some higher risk asset whose return on regulatory capital helps the average return on regulatory capital to become acceptable. Absent this booking of a very high risk asset, the bank cannot afford to book the low-risk, low yield asset.

In the U.S., moreover, the minimum regulatory leverage ratio requirement of 3% has not been the binding leverage requirement; or was the 5% "well-capitalized" leverage ratio requirement embedded within legislation the binding requirement. Rather, bank examiners in the past -- and especially in the middle of this crisis -- have been suggesting, sometimes insistently, that banks hold leverage ratios of 8% or more. Effectively, these leverage ratio rules guarantee that banks must avoid booking ordinary loans with yields below approximately 120 bp above Libor, *plus* net non-interest expenses (assuming that a reasonable return on capital is 15%). Thus, we believe that the U.S. leverage ratio requirements, especially the supervisory interpretations of these requirements, have been, and now are, among the greatest impediments to low-risk credit activities.

At the same time, we do not condone some of the high-risk activities that had been undertaken by some U.S. banks -- not because the activities were high risk, but because some departments in some banks either did not truly understand the nature of the those risks or ignored the risk measurements and placed credit bets without allocating appropriately high capital to these bets. This is why we are supporters of the Committee's recent efforts to improve risk-based capital allocations, subject to our concerns over proper implementation of such changes.

5. Take care to eliminate the very significant cross-country inequities associated with accounting for securitization sponsorship, as it pertains to a new leverage ratio requirement. In particular, banks in the U.S. that sponsor securitization programs must now hold the underlying assets on the books of the bank and hold, as well, full risk-based and leverage ratio capital requirements against these newly consolidated assets. Often, the first-dollar

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<sup>2</sup> We arrive at this regulatory risk-based Tier 1 requirement by inputting a PD of 0.05% into the BII ASRF credit risk model, along with a 40% downturn LGD. This then results in a Total Capital requirement of 0.798% and a Tier 1 capital requirement of half that amount. But ICAAP and bank supervision requires that the bank holds a multiple of that capital ratio requirement. If best-practice Economic Capital measurements suggest a capital charge of substantially less than this multiple, then it is the risk-based capital charge that is binding and the leverage charge may be non-binding.

loss position retained by the bank sponsor of a securitization amounts to 5 or 10% of the underlying assets. Therefore, in countries that don't require accounting consolidation of the underlying assets, the leverage ratio requirement would be 1/10th or 1/20th of that required in the U.S. or in other countries that require accounting consolidation. Thus, simple fairness requires that such sponsored securitized assets be consolidated in all Basel countries, for purposes of the regulatory leverage ratio requirement.

If these steps are taken, there will be a reduced chance that a new Basel leverage ratio will induce inappropriately high risk-taking, and an increased chance that a leverage ratio would fulfill its desired role as that of a fail-safe mechanism to back-up risk-based capital measures. Still, we do not believe that a leverage ratio requirement will have any positive effect on bank soundness and that the leverage ratio's proven track record of inducing higher risk-taking will outweigh any psychological benefit it may carry. We believe this view is shared by the vast majority of risk practitioners and economists.

#### B. Changes to the treatment of loss provisions.

We agree in general with the Committee's desire to increase loan loss provisioning. The specific proposals are to i) make sure that the accounting treatment of the Allowance for Loan and Lease Losses (ALLL) would reflect Expected Loss (EL) over the life of the portfolio, and ii) change the capital treatment of the ALLL so that shortfalls of the ALLL less than estimated EL would be deducted 100% from Tier 1 capital rather than 50-50 from Tier 1 capital and Tier 2 capital.

We believe that Committee efforts to move the accounting treatment of the ALLL so as to accurately reflect EL over the life of the portfolio make sense. However, international movement toward such an accounting goal is problematic and, as well, tax treatment of provisions in some countries hinders effective reserve creation and creates competitive inequities. As an example, in the U.S., current accounting treatment varies widely across banks, so that some accountants permit the ALLL to reflect EL, including EL over a longer horizon than one year, while other accountants do not. Indeed, current written guidance on the accounting treatment of the ALLL suggests that the reserve should cover only actually incurred but not yet identified losses.<sup>3</sup> Some accountants interpret this guidance quite literally, saying that the ALLL *cannot* be as high as the expected losses over the life of the portfolio.

Additionally, current U.S. tax law does not allow any provisions in excess of actual current period losses to be tax deductible as an expense. Unfortunately, the Committee is proposing to not count as Common Equity any Deferred Tax Assets (DTAs) that arise as a result of tax treatment of excess provisioning. Thus, while the Committee's objectives for the ALLL are laudatory, we suggest an alternative set of treatments that would a) eliminate competitive inequities, and b) provide necessary incentive to keep loan loss reserves sufficiently high. Specifically, we suggest:

- First, keep the current 50/50 deduction for ALLL less than EL, since this would more accurately reflect differences across Basel countries in their accounting ability to

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<sup>3</sup> "The estimate of loss in pools of loans should reflect losses that have already been incurred, even if not yet identifiable, and not losses that might be incurred over the remaining life of the loans, even if predictable based on historical experience", Exposure Draft, Proposed Statement of Position, Allowance for Credit Losses, June 19, 2003, Accounting Standards Executive Committee, AICPA.

book high provisions. Alternatively, the Committee could move the ALLL to Tier 1 (where it was in the late 1980's and where it is now viewed by the world's rating agencies), so as to provide the greatest possible incentive to keep high reserves. Under this proposal, excess ALLL>EL would still count as Tier 1 but an ALLL<EL shortfall would be deducted from Tier 1.

- Second, we suggest that any DTAs created as the result of provisioning more than actually incurred losses NOT be deducted from capital. Note that we also believe that it makes economic sense to NOT deduct from Common Equity some of the rest of DTAs, which we discuss below.
- Third, because of the likely long delays in achieve international harmonization of provision accounting, we suggest that, in the interim, banks be allowed to create additional loan loss reserves for regulatory capital purposes. Absent such a temporary process, banks in the U.S. will be especially hindered in raising the ALLL to the level of EL through the life of the portfolio. Alternatively, in countries where the accounting treatment of provisions limits the ALLL, those countries could maintain the current treatment of ALLL<EL shortfalls -- a 50/50 deduction from Tier 1 and Tier 2 capital.
- Fourth, we applaud the Committee's suggestion that the current cap on the ALLL>EL should be eliminated. The ALLL is the first place that absorbs realized loan and lease losses, just as retained earnings are the first place that absorbs other types of losses. No limits should be placed on either type of capital buffer.

#### C. Deduction of certain assets from Common Equity.

1. Certain intangibles. Mortgage Servicing Rights. Some intangible assets do not have readily available sale values and thus cannot provide liquidity in a downturn. Other intangibles do have sale value (such as the market value of credit card accounts over and above their carrying value). In the case of Mortgage Servicing Rights (MSRs), however, the term "intangible" is inappropriately applied. MSRs are a written, tangible, legal contract like any other financial asset. MSRs have an ongoing market for their value, and firms can sell MSRs and their associated servicing facilities and staff, both in a going concern situation as well as in conservatorship or receivership. For these reasons, we believe that MSRs should not be deducted from regulatory capital.
2. Deferred Tax Assets. DTAs in the U.S. are not deducted from capital to the extent that such DTAs can be utilized within a 12 month going-forward projection of taxable income. As we noted above, we believe that cross-country equitable treatment of DTAs generated from provisioning in excess of tax-deductible, actually realized losses should never be deducted from capital. In addition, we suggest that the U.S. rule be applied to all other DTAs (over and above DTAs created by excess provisioning) -- that is, DTAs that can be shown to be usable over a short-term horizon would not be deducted from capital.<sup>4</sup>

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<sup>4</sup> Note that we do not agree with the regulatory view that DTAs become useless in a crisis. This is because DTAs can become valuable to other business partners, acquirers, or new investors with any bank that is not generating positive taxable income. As just one example, the cash from new investment in a suddenly

#### D. Treatment of securitization positions beyond sponsorship activities.

As we discussed above, we believe that competitive equity and best-practice capital allocation should involve the consolidation, for regulatory capital purposes, of sponsored securitization activities that meet the standards of the new FAS 166 and FAS 167 in the U.S. To do otherwise, would generate huge cross-border inequities, especially in the application of any new leverage ratio requirement. Additionally, there are at least two other proposed treatments of securitization positions that are of concern.

1. Banks that hold a first-dollar credit enhancement position but are not the sponsor of the securitization. The new proposal calls for assigning a 1250% risk weight to such a position rather than to deduct it 50-50 from Tier 1 and Tier 2 capital. As a result, the effective Tier 1 capital requirement would be approximately doubled.<sup>5</sup> Our view is that the true, risk-based Tier 1 requirement for such a position should depend primarily on the risk quality of the underlying asset pool. In particular, if the risk-based capital requirement as if the bank owned the underlying assets is X (from a Tier 1 perspective), then a first-dollar loss position that exceeds X should not receive a 100% Tier 1 capital charge but rather should incur the same capital charge as if the bank was subject to losses on 100% of the pool. A 100% Tier 1 charge against the securitization position should only be incurred if the first-dollar position was *less* than the X% of the pool constituting the Tier 1 capital requirement as if the bank held the entire pool.

Granted, a bank owning such a first-dollar position may not be in the position of having the data necessary to calculate the true Tier 1 risk-based capital requirement as if it owned the whole pool. But we agree with the recent Basel ruling that any bank that owns a securitization position should not rely solely on the position's rating to determine appropriate capital, but rather should conduct some sort of look-through analysis that involves data on the underlying pool assets on a continuing basis. This Pillar 2 rule should certainly apply to first-dollar positions, and we would go so far as to say that no bank should own a first-dollar loss position if it does NOT have access to the data and skills necessary to compute the true risk of the position, based on the pool's asset quality.

2. Banks that are not a sponsor and that own a senior tranche whose underlying assets have deteriorated to reduce the rating of their position to more than one grade below investment grade. Under the new proposal, the capital charge for this position would be a 1250% risk weight instead of a 50-50 deduction from Tier 1 and Tier 2.

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under-capitalized bank can generate immediate taxable income. Also, an acquirer of an under-capitalized bank may be able to use the DTAs if the acquirer is in a taxable position.

<sup>5</sup> To see this, note that as a practical matter, supervisors want banks to hold actual Tier 1 capital-to-RWA ratios that are 8% to 10% -- roughly 2 to 2.5 times the minimum. When the deduction of the asset is 50/50, there is an effective true Tier 1 capital charge of 50% of the asset value -- Tier 1 is reduced by 50% of asset value, and total RWA falls by 100% of the asset value. When the risk-weight is 1250%, the marginal Tier 1 minimum capital charge is 50% of the asset-value, but this rises to 125% of asset value if the supervisor wants to see a 10% Tier1/RWA capital ratio. The bank is being asked literally to hold Tier 1 capital equal to more than the asset!

Effectively, this proposal doubles the Tier 1 capital requirement of a B-rated senior position and can effectively make the Tier 1 capital requirement 100% or more (see footnote 5 above). This is much too conservative for a senior position.

This is because, as an underlying pool deteriorates and the ratings of each piece fall, the difference in risk between a senior piece and a mezzanine piece becomes driven by differences in LGD. That is, if pool performance causes losses on the thin mezzanine piece to be incurred, such losses are likely to be close to 100%. But, if pool losses chew through the mezzanine piece and affect the senior piece, the LGD of this senior piece might approach, in an extremely stressed circumstance well beyond the current crisis, perhaps 20% at most.<sup>6</sup> Indeed, a 100% loss rate on a senior piece could not occur unless each loan in the underlying pool defaulted and each loan suffered a 100% LGD. Thus, an effective 100% Tier 1 capital charge against the senior piece is all out of proportion to its riskiness.<sup>7</sup> Therefore, retaining the current 50/50 deduction for senior positions at a rating of B+ or lower is, while still quite conservative, preferable to the 1250% risk weight.

#### E. Capital buffers.

The Committee views its proposal regarding a formal capital buffer zone as one element in reducing pro-cyclicality of capital requirements. However, the proposed capital buffer process appears to serve some of the same purposes as the Pillar 2 Internal Capital Adequacy Assessment Process (ICAAP). Under ICAAP, which is treated within the U.S. currently as part of SR-99-18 examinations, the banking company is supposed to develop an internal capital allocation that is above the regulatory risk-based minimums and the leverage ratio minimum. Clearly, much has been done in this arena, because such actually held capital does indeed surpass the Pillar 1 minimums by a substantial amount.

The critical issue, therefore, is whether the hard-wiring of the capital buffer process within a formal Pillar 1 regulation, as proposed within BCBS 164, should be preferred to a process that is essentially driven by supervisors on a case-by-case basis. One can easily imagine cases in which the hard-wiring would have the opposite effect of that intended. For example, if the bank attempts to significantly

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<sup>6</sup> For example, if the first-dollar piece plus all the mezzanine pieces and sub-senior pieces accounted for 25% of the pool, a 20% loss rate on the senior piece would mean that pool losses would total 40% (the original 25% absorbed by the prior credit protection plus the 15% of the pool that constitutes 20% of the 75% senior tranche). Such a pool-wide loss rate is a multiple of observed credit losses, even at the height of the current crisis, even for a sub-prime pool. For example, a pool loss rate of 40% would mean that 80% of the pool must default and 100% of these defaults would have to suffer 50% loss-given-default rates. Even under the old 50/50 deduction, a true 50% Tier 1 capital charge for the senior position is way out of proportion to its risk.

<sup>7</sup> As discussed in footnote 5 above, a 1250% risk weight translates into a Tier 1 capital charge of 100% or more of the asset value so long as supervisors want the bank to hold Tier 1 to RWA ratios at least twice the 4% minimum under Basel. Note further that the 1250% risk-weight is being proposed for other positions as well (in lieu of the current 50/50 deduction -- see Paragraph 107 in BCBS 164). Effectively, the 1250% risk-weight will be translated by supervisors into a greater than 100% capital charge for Total Capital and possibly a greater than 100% Tier 1 capital charge, simply by requiring that the bank hold a Total Capital to RWA ratio of *greater* than 8% (and possibly a Tier 1 Capital to RWA ratio also of *greater* than 8%).

increase the ALLL in a forward-looking manner, this might send a negative signal to the market as the Tier 1 RWA ratio declines toward the top of the buffer zone.

Indeed, we do not see how the buffer zone concept can avoid being viewed, in effect, as the new minimum capital requirements. Any bank worried about the market's perception of its soundness must always maintain a capital buffer above this new set of minimums. The Committee worries about just an effect on page 69 of the Consultative Document:

*"The Basel Committee does not wish to impose constraints for entering the range that would be so restrictive as to result in the range being viewed as establishing a new minimum capital requirement."*

This is our main concern as well, and we can see where formal triggers that lead to reductions in payouts, whether for dividends or corporate bonuses, could have a market effect out of proportion to that intended by the Committee.

Therefore, we respectfully suggest that the capital buffer triggers be set by individual supervisors with respect to individual institutions. If the risk-taking activities of the bank are a concern to supervisors, they might say, as they do now, that failure to meet a specific risk-based capital ratio above the minimum, for that particular institution, would have specific consequences. This removal of the hard-wired nature of the proposed buffer would eliminate inappropriate market responses to specific entrenching maneuvers by specific institutions.

Alternately, the Committee could set a specific buffer zone for a specific risk-based capital ratio that would trigger a supervisory review as to whether capital needs to be conserved and, if so, by how much. This supervisory trigger might be especially useful in those Basel countries where full-time, in-house bank supervision of the largest banking organizations does not now take place. Thus, we agree with the general view that a buffer is needed, but we advise extreme caution on the part of the Committee with regard to specifying triggers and required actions, even in countries where Pillar 2 supervisory oversight is not currently all that it can be.

Importantly, our recommendation that a specific regulatory buffer be replaced with a bank-by-bank specific buffer, would permit the supervisory buffer zone to be a matter strictly between the supervisory and the banking company -- something that would not be publicly disclosed. In the U.S., bank and BHC supervisory ratings, including the capital adequacy component of the ratings, are confidential and for good reason. Only the supervisor knows the full details of the bank's ICAAP (SR99-18) calculations, and only the bank and its supervisors know the supervisory response to these calculations. At times, the size of the buffer zone depends critically on the degree to which the supervisor has confidence in the quality of the bank's reference database and risk parameter measurement processes.

We believe that such a supervisory-based buffer zone concept is superior to a hard-wired buffer zone for the reasons discussed above. In the supervisory-based process, the bank would not be subject to market misconceptions about capital adequacy that would be associated with a specific upper bound to the buffer zone. Also, the supervisory-based method does not effectively require that a bank hold a buffer of capital above the buffer zone -- i.e., the bank doesn't need to hold a buffer above what is, in effect, a new higher capital ratio requirement. At the same time, the supervisory process itself can be used to ensure that banks do indeed build up capital during good

times, by meeting higher, confidential capital ratio targets of supervisors. When bad times occur, these buffers can then be eroded without triggering reactions that might be counter-productive to the maintenance of a sound banking system in which the public has confidence.

## II. Other specific concerns.

### A. Establishment of a new Common Equity to Risk-Weighted-Asset ratio.

We don't believe that creation of a new RWA-based capital ratio requirement based solely on Common Equity (CE), will improve bank soundness, so long as the Committee follows through on some of its proposals to strengthen the CE that is included within Tier 1 capital. Assuming these proposals are implemented, subject to our major concerns regarding cross-border competitive equity, the major Tier 1 capital-type, over and above Common Equity, will continue to be non-cumulative perpetual preferred stock. With such an instrument, the bank has total control over when and how much of a payout the bank makes on the stock, although the stock typically has a notional interest rate associated with it.

In the time leading up to a severe downturn, one could expect banks to not only suspend or reduce corporate bonuses and corporate common-stock dividends, but also suspend dividends on non-cumulative preferred stock. Thus, perpetual, non-cumulative preferred stock serves essentially the same buffer protection as common stock. Additionally, in the event of conservatorship or receivership, this type of preferred stock absorbs losses immediately after common stock and before all forms of liabilities, including subordinated debt (Tier 2) capital. Thus, we see no reason to distinguish non-cumulative, perpetual preferred from common equity and therefore no reason to establish another ratio besides the Tier 1-to-RWA minimum capital ratio.

The addition of another minimum capital to RWA ratio could cause confusion among investors and other stakeholders, especially since there will already be 3 capital ratios -- the new leverage ratio, the Tier 1 to RWA ratio, and the Total Capital to RWA ratio. However, because we see neither significant benefits nor significant downsides to the establishment of a Common Equity risk-based capital ratio we do not oppose its formation.

### B. Review of securitization capital charges and the hierarchy approach.

The Consultative Document also indicates that regulatory staff is conducting an analysis of the current securitization approach, including a possible recalibration of the capital charges under the Supervisory Formula Approach as well as the necessity of using the hierarchy rule. We support any such review based on best-practice risk measurement. We wish to note only that the SFA can be extraordinarily expensive to implement and should not be necessary in cases where the rating appropriately takes account of pool characteristics and asset-value correlations. At the same time we agree with the Basel view that bank holders of securitization tranches (other than the case where the bank consolidates the trust's assets) should conduct an appropriate analysis of the risk of the underlying assets on the way to assessing the risk of the particular tranche the bank owns. We await details of any new proposal(s).

### C. Additional measures to reduce pro-cyclicality.

While it is desirable to reduce the pro-cyclicality of capital requirements, we are greatly concerned that simple measures to do so are fraught with problems. In addition to the concept of a buffer zone of capital to be built up during good times, as discussed immediately above, the Committee proposes 2 other processes to help in reducing pro-cyclicality.

#### 1. Changing the PD estimation process for purposes of the Basel II credit risk models.

The Committee is concerned that PD estimates applied to classes of credit asset (such as the PDs applied to particular internal rating grades) may fall during good times and rise during bad times. The Committee is looking at two particular proposals to reduce this cyclicality.

- a. Use the highest PD applied by the bank historically to a particular exposure class.
- b. Use the average of historic PD estimates for each exposure class.

We comment on these two proposals together. To begin, note that the Committee's concerns over the pro-cyclicality of PD estimates are likely based on significant differences across banks and across countries in the estimation of the *through-the-cycle* PD estimates required under the BII A-IRB approach. In theory, this TTC PD estimate should indeed be invariant with the cycle. But all such PD estimates are based on historical reference databases that, for individual exposure classes, are incomplete due to practical difficulties such as the impact on reference data of historical mergers and acquisitions. Moreover, most BII banks had started to build their historical reference databases only within the last decade or so, so that the current crisis is the first true downturn for particular exposure classes.

Thus, without any action of the part of the Committee, we would expect that estimates of TTC PD should begin to stabilize. Further, we believe that the supervisory process itself can assist in achieving this stability via heavy emphasis by examiners on best-practice in the estimation of TTC PDs. Note, however, that even a mandated unvarying PD used within the Basel II credit risk models would still not eliminate pro-cyclicality of capital requirements, because of the inherent cycle-affected internal ratings processes of major banks. That is, essentially all banks have internal rating procedures that, to varying degrees, will result in some exposures being down-graded (up-graded) during bad (good) macro conditions -- therefore, these exposures will be subject to the application of higher or lower PDs, because some commercial enterprises are naturally sensitive to the cycle.

The first of the two ways the Committee proposes to stabilize PD estimates is, in effect, to use a downturn PD instead of a TTC PD as the risk parameter to be plugged into the BII credit risk models. Such a process would effectively negate the stress-test embedded within the Basel asymptotic-single-risk-factor (ASRF) credit risk model for determining capital. That is, the model works by positing a *distribution* of possible realizable default rates, while assuming that the realizable loss-given-default rate is itself the downturn LGD. Then, the model requires the use of a specific confidence interval so that the actual realized default

rate is the one occurring when a draw of the macro-economic risk factor is very bad -- a macro condition that is worse than one would observe 99.9% of the time.

If Basel were to use the downturn PD observed during the current crisis (or any past downturn, or some assumed downturn) while continuing to use the ASRF credit risk model, the result would be what amounted to a *stressed stress test*. The resulting capital requirement would be arbitrarily and untenably high. Indeed, the resulting 99.9th percentile default rate would be very significantly worse than those experienced in the current crisis or whatever was the chosen stressed PD. This would lead to capital requirements that would severely restrict the lending needed to maintain economic activity, let alone allow macro-economic growth.

The second way of stabilizing PD -- to use the average of historic PD estimates for an exposure class -- sounds to us to be, in fact, the way typically used to estimate PD for the ASRF model within the BII A-IRB process. For example, within commercial lending, many BII banks measure the realized default rate over a one year horizon for, say, Grade X, for each year over the past Y years. The PD for that grade, in turn, is simply the average of the Y years' of actual default frequencies. This average changes each year as a new year's worth of data is entered into the historical reference database; so, therefore, the historical average PD changes somewhat every year. However, as more and more years of data are entered into the database, the resulting average PD will not be moved very much by the addition of either a very good year (low observed default rates for Grade X) or a very bad year (high observed default rates for Grade X).

Moreover, the year-to-year changes in the PD for a given grade are likely to be less important in driving calculated capital requirements than the amount of upgrades or downgrades of individual credit in response to macro conditions. Thus, we believe that a preferable approach to stabilizing PDs (for BII purposes) would be to use the supervisory process to make sure that PD estimation at each individual bank is conducted in a manner that a) uses a complete cycle of realized default frequencies to establish the TTC PD, then b) changes the resulting PD only after another complete cycle of realized default frequencies is observed. This would result in the use of very stable PDs while not setting the default rate at a stressed level before it is then plugged into the ASRF model stress process.

## 2. Adjusting the capital buffer range in response to macro economic conditions.

The last proposal to be found within the Consultative Document is one that would tie the size of the capital buffer zone to credit conditions in relationship to economic activity. Thus, for example, if the ratio of "credit to GDP" grew well above its long-term trend, each jurisdiction's supervisory authority might increase the required buffer zone. The Consultative Document suggests that such a process would NOT be hard-wired as a formal regulation-based process, but rather would be up to individual countries.

We agree that one could not have a high degree of confidence, statistically, in the ability of any specific economic variable, or set of variables, to provide an indication of a surfeit of credit activity. Also, one could easily envision situations in which a specific economic event could distort a ratio -- such as the case when a natural disaster would cause GDP to plummet, thereby driving up the credit-to-GDP ratio. It would also be difficult to statistically

determine what variable, or set of variables, could be most appropriately defined to measure "credit". Finally, the calculation and use of such credit-to-economic activity ratios could lend themselves to political influence, thereby greatly complicating supervisors' job of seeing that banks and the banking system do their job of supporting economic activity while maintaining adequate levels of soundness.

Therefore, we believe that the monitoring of the relationship between credit activities and macro-economic activity should continue to be explored both by academics and banking supervisors. However, we are not yet at the point where even a broad set of principles for the use of a capital buffer zone to foster counter-cyclical capital formation can be established. Again, we believe it best if counter-cyclicality in general is fostered via the supervision process, in which supervisors promote capital buffers specific to individual institutions, depending on the details of that institution's risk profile and risk measurement and management capabilities. Moreover, these bank-by-bank decisions should be confidential in nature, to avoid any unintended market reactions to capital ratios and other highly imperfect indicators of risk and soundness.

Finally, we wish to express our appreciation of the Committee's efforts to address the important issues before us. We agree with the general intent of the Committee and, in many cases, with its specific proposals, as discussed above. In addition, we wanted to express our broad agreement with:

- Raising the Asset-Value-Correlation for large financial institution counterparties. However, the choice of a specific AVC 25% higher than the current AVC may not be fully warranted by the data. More importantly, the application of this higher AVC to regulated entities with asset sizes of only \$25B may include banking firms that are not remotely of systemic importance. Similarly, including all non-regulated entities within this AVC category, regardless of size, would capture many very small hedge funds and other financial firms that also are not systemically important.
- Requiring an internal bank review of the appropriateness of an external rating of a counterparty (whether in the Standardized or A-IRB processes).
- Allowing a guarantor with a lower rating than A- to be used within the process of estimating the risk of a credit position that enjoys a guarantee.

We stand ready to answer any questions and provide any assistance to the Committee on these matters.

## **Appendix**

### **RMA Capital Working Group institutions participating in the preparation and/or review of this response<sup>8</sup>**

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**Mingo & Co:** John Mingo, Managing Director.

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<sup>8</sup> Individual institutions in the Capital Working Group may have opinions that differ from those expressed in this Response and, as well, individual institutions may be responding to the ANPR separately from this Response.