James H. Hance, Jr.
Vice Chairman &
Chief Financial Officer

Bank of America Corporation
100 North Tryon Street
NC1-007-58-03
Charlotte, NC 28255

Tel 704.386.7722

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

Basel 2003 Capital Proposal
Board of Governors of the Federal Reserve System
Mail stop 155
20th Street and Constitution Avenue NW
Washington, DC 20551

Basel 2003 Capital Proposal
Office of the Comptroller of the Currency
Mail Stop 3-6
250 E Street SW
Washington, DC 20219

Re: Basel Committee on Banking Supervision
Third Consultative Paper "The New Basel Capital Accord"

Dear Messrs. and Mmes.:

Bank of America Corporation ("Bank of America") appreciates the opportunity to comment on the third consultative document entitled "The New Basel Capital Accord" (the "Revised Proposal"). Bank of America, with $769 billion in total assets, is the sole shareholder of Bank of America, N.A., with full-service consumer and commercial operations in 21 states and the District of Columbia. Bank of America provides banking and investing services, corporate and investment banking services, and financial products and services to individuals and businesses across the United States of America and around the world.

Over the last decade, the banking industry has evolved and transactions have become increasingly complex. During this time, the limitations of the existing capital Accord have become apparent, highlighting the need for regulatory capital requirements that appropriately reflect the risks associated with the operations of individual banks and the industry as a whole. We strongly support the Committee's direction towards establishing capital regulations that not only encompasses minimum capital requirements, but also includes supervisory review and market discipline as part of a comprehensive risk-based capital approach.

We commend the Committee's efforts to establish a broadly accepted and reasonable basis for calculating minimum capital requirements. We acknowledge that the Committee has made significant progress in this regard. We appreciate the Committee's efforts to promote transparency through the consultative dialogue it has maintained with the industry. We support the efforts of the Committee to better align

regulatory capital requirements to underlying economic risks, to encourage better risk measurement and management processes and to promote international consistency in regulatory standards. Although we generally support the Committee's approach in the Revised Proposal, we remain concerned with the direction that the Committee has taken in the following areas:

- Treatment of expected losses
- Prescriptiveness of the Revised Proposal
- Cumulative effect of conservative assumptions
- Limited recognition of credit risk hedging
- Maturity adjustments
- Retail exposures
- Complexity of the securitization framework
- Counterparty credit risk
- Supervision
- Excessive disclosure requirements

We support the addition of operational risk as it strengthens the overall risk-based capital framework and aligns the regulatory capital approach with newly developed internal risk methodologies.

Bank of America plans to adopt the Advanced-Internal Ratings Based ("A-IRB") approach for credit risk and the Advanced Measurement Approach ("AMA") for operational risk. With this in mind, we have limited our comments to these two approaches. Bank of America is a member of the Institute of International Finance ("IIF"), the Risk Management Association ("RMA") and the International Swaps and Derivative Association ("ISDA"), and has participated in the preparation of the comment letters of those organizations as well as other groups. With some minor differences, we endorse the comment letters of those organizations. Therefore, we have refrained from repeating many of the more technical comments common to Bank of America, IIF, RMA and ISDA.

Treatment of Expected Losses ("EL")

The Committee has adopted a definition of capital that encompasses both expected and unexpected loss. As expressed in our previous comment letter, we strongly believe that it is inappropriate to assign capital for expected loss. We are not aware of any industry practitioners who include EL in their economic capital assessment; it is either covered by loan loss reserves or absorbed by the revenue of business activities. Assigning regulatory capital for EL implies that no revenue is generated by the business activities during the capitalization horizon.

We strongly recommend that the EL component of the capital charge be eliminated. This is the industry-standard methodology and significantly simplifies the Revised Proposal. If removing EL is unacceptable, the Committee should evaluate other alternatives that avoid unnecessarily complex implementation requirements. The best alternative would allow banks to recognize 100% of loan loss reserves as Tier 1 capital. The 50% cap on Tier 2 capital as well as the 1.25% cap on general provisions present in the current definition of regulatory capital should then be removed.

As a second, but less desirable alternative, future margin income ("FMI") should be allowed to offset the EL component of the capital charge without limit. The current proposed limitation of the FMI offset to

75% of EL should be eliminated; banks should be allowed to offset 100% of EL using FMI. We also do not believe that the circumstances applying to qualifying revolving retail portfolios are so unique as to warrant only giving these portfolios the benefit of offsetting EL with FMI. We accordingly urge the Committee to expand to all exposure categories the ability to offset EL with FMI.

Prescriptiveness of the Revised Proposal

The Revised Proposal remains excessively prescriptive. It establishes Pillar 1 minimum requirements that cover everything from corporate governance to the specific fields included in the bank's databases. We understand the delicate balance the Committee must maintain between the desire for consistency among countries and the risk of creating a burdensome and prescriptive approach. However, we feel the balance between these competing objectives has not yet been found.

The approach should be unambiguous and verifiable but should not undermine the continuing evolution of risk management. It should be flexible enough to accommodate the development of new financial products and risk mitigation techniques. The inadequacy of the current rules-based Accord became apparent in recent years as it failed to meaningfully measure the risk faced by banks and did not adapt to new products and risk mitigation techniques. It will be unfortunate if the inflexibility of the Revised Proposal causes Basel II to suffer the same fate.

Many elements of the Revised Proposal codify best practices for financial institutions. However, to satisfy *all* of the Revised Proposal's prescriptive requirements, banks will be required to add infrastructure that cannot be leveraged to enhance shareholder value or improve management practices. In certain instances, the specific proposals are even at odds with internal risk management processes. Decisions concerning the form, structure and prioritization of risk management processes and system enhancements should be left to individual banks.

By defining a narrow set of requirements, the Committee discounts the benefits of well-designed risk management practices that are customized to fit the circumstances and business needs of the institution. This may require banks to maintain dual processes, one to manage the risk of the bank and one to comply with the Revised Proposal. Even worse, there may be cases where the bank is actually forced to abandon a superior approach in order to achieve compliance with the specific rules of Pillar 1. The following examples highlight just a few of these cases:

- The Revised Proposal requires that facility ratings of A-IRB banks exclusively reflect Loss Given Default ("LGD"). An alternative methodology utilizes a more comprehensive approach that includes LGD as an input to a rating based on EL. Although different in form, this methodology is consistent with the substance of the Revised Proposal.

- Banks are required to associate credit risk hedges with individual exposures in the portfolio even though banks do not typically hedge on an individual transaction basis. Rather, the amount and maturity of the hedge is set in a portfolio context taking into consideration the aggregate amount and maturity profile of the bank's exposure to the borrower.

- The credit mitigation rules require that collateral be explicitly linked to individual facilities. Banks often manage collateral on a pooled basis. This collateral supports all of the transactions

executed under the collateral agreement. No risk management value is achieved by artificially allocating that collateral to individual transactions in order to comply with Pillar 1 requirements.

These are only a few of many examples that could be drawn from the Revised Proposal. Narrow application of these and similar rules will require banks to modify their risk management practices for compliance or develop dual processes even though the existing systems represent a superior approach for internal risk management.

We urge the Committee to pursue a more principles-based approach and to reduce the level of prescription throughout the document. Greater emphasis should be placed on the Pillar 2 supervision process. Rather than a detailed set of complex Pillar 1 requirements, supervisors should establish strong guidance and outline the principles for risk management policies and practices in Pillar 1 and then assess the appropriateness of the methods applied under Pillar 2. This will establish a nimble and risk-sensitive approach that can appropriately reflect each bank's unique risk profile and adapt as the financial products and risk management techniques evolve.

Cumulative Effect of Conservative Assumptions

We strongly support a prudent level of conservatism to ensure that the risk inherent in businesses is adequately considered. However, the Revised Proposal establishes an approach that will not yield a true minimum capital requirement as envisioned by the Committee. The Revised Proposal is a complex document that reflects many conservative decisions with regard to parameter values, formula options and constraints. Considered in isolation, each of these conservative choices appears logical. Collectively however, their effect generates a capital amount that is unduly conservative and well exceeds a true minimum capital requirement. This level of conservatism is highlighted by the following examples:

- The confidence levels chosen as reference points contradict the goal of a minimum standard. The requirement to measure credit and operational risk at a 99.9% confidence interval approaches the level that is used by banks for economic capital purposes. This high confidence interval equates to an investment grade or "well capitalized" target level of capital rather than a minimum standard of capital adequacy. A more appropriate confidence level for a minimum standard is 99.5%, which is approximately the border between investment and non-investment grade.

- The Revised Proposal inadequately considers the full economic benefit of credit hedging. As we discuss later, the substitution approach does not recognize the lower risk of joint default and joint recovery and accordingly does not appropriately reflect the risk of these transactions.

- The Revised Proposal fails to recognize the benefit of diversification between different portfolios (e.g., wholesale and retail), risk types, geographies and industries. Diversification is an important and effective risk-mitigation technique; we urge the Committee to recognize this benefit in the Revised Proposal. Acknowledging and providing capital relief for well-diversified portfolios will have the added benefit of encouraging sound management practices and reducing overall risk exposure.

- The ranges of asset value correlation prescribed in the retail section exceed those used by the industry in many cases by more than 50%.

- The 10% LGD floor for mortgages fails to consider mortgage insurance and the possibility of low loan-to-value ("LTV") ratios.

- The incorporation under the A-IRB approach of a floor of 90% in 2007 and 80% in 2008 for total minimum capital seems arbitrary and unnecessary. U.S. Banks have to meet all the requirements, obtain approval from supervisors and perform parallel calculations under the A-IRB approach for 1 year prior to adoption. The additional benefit that could be derived from the floors after the parallel calculation period is not clear.

Although a minimum standard is necessary to ensure the financial soundness of individual banks and the banking industry as a whole, the Revised Proposal currently prescribes a level of capital well beyond a true minimum standard. We urge the Committee to address the overly conservative nature of the Revised Proposal.

Limited Recognition of Credit Risk Hedging

Credit risk mitigation techniques have evolved significantly over the last decade in both effectiveness and volume. The Revised Proposal attempts to capture the benefits of credit risk hedging and guarantees through substitution. This approach simply substitutes the default probability of the guarantor for that of the borrower when determining risk weightings. However, both the obligor and the guarantor must default for a bank to experience a loss on a hedged exposure. Banks may also be able to seek recovery from both counterparties. Therefore, the final Accord should recognize the lower probability of joint default and the lower LGD of joint recovery in the treatment of credit hedging and guarantees. Banks should be permitted to calculate joint default probability using the same correlations as used elsewhere in the regulatory framework for corporate exposures (i.e., 20%). For related entities such as subsidiaries and parent companies, the correlation assumption should be set conservatively to 100%. This effectively yields the same result as the substitution approach. In cases where the bank can pursue recoveries from both counterparties (e.g., CDS), a joint LGD is appropriate. ISDA has proposed an alternative approach that recognizes double-default while balancing it with the supervisors' concern over the correlation between the obligor and the guarantor. Even with a conservative assumption of correlation (e.g., 50%), this approach yields meaningful discounts to the substitution approach. We urge the Committee to consider these alternatives, as we do not believe the Revised Proposal provides a reasonable solution.

The treatment of maturity mismatches is unduly conservative and unnecessarily complex. The proportional adjustment mechanism is far more conservative than the treatment of maturity for corporate exposures. There is little reason to implement two separate sets of maturity adjustments. Maturity mismatches between credit hedges and the underlying assets should be reflected by calculating a capital offset for the hedge using the standard A-IRB formula. This capital offset should be subtracted from the capital requirement of the underlying asset. The counterparty risk of the hedge should be reflected as an exposure with joint default probability and recovery. This approach essentially treats the maturity mismatch as a forward credit exposure using the standard A-IRB approach.

We are also concerned by the prohibition of capital relief for hedges with a maturity of less than 1 year when the maturity of the hedged asset is longer than 1 year. This eliminates the benefit in the final year of any hedge. We strongly believe that these hedges remain valid risk-reducing instruments and that banks should be afforded capital relief for these instruments. We acknowledge that the declining value of the hedges must be recognized as they approach maturity. We recommend that the risk associated with

the shorter maturity be calculated using the corporate A-IRB risk weighting function and the maturity adjustment described in the next section.

Maturity Adjustments

We strongly support the inclusion of a maturity adjustment in the risk-weighting formula to appropriately differentiate the risk of instruments with different tenors. With exceptions for capital market transactions and certain one-off transactions, the Revised Proposal currently contemplates a sliding scale for maturities from 1 to 5 years. This ignores the different risk attributes of assets with tenors outside this limited range. We urge the Committee to remove these restrictions and allow an open-ended maturity scale consistent with industry practice.

The limited maturity range is of particular concern for short-term transactions. To address this issue, the Committee need not add complexity by creating additional rules, but should allow a simple extrapolation procedure to adjust the 1-year default probability for the remaining term. For example, an asset with a remaining maturity of 3 months should be assigned a default probability that is .25 times the 1-year default probability. A non-linear adjustment could also be considered, however, the differences relative to linear interpolation are negligible and not worth the additional complexity. In addition, extrapolation would avoid obvious discontinuities and "cliff" effects. If necessary, the Committee could establish a reasonable floor, such as 1 month, to constrain the minimum default probability.

We understand the concern that banks will be tempted to minimize capital requirements by rolling over sequential short-term transactions rather than originating a long-term transaction. However, we believe that such behavior, when accompanied by an explicit decision to renew based on the customers evolving credit quality, is legitimate. In fact, controlling exposure to borrowers through limiting the maturity of transactions should be considered a favorable risk mitigation technique.

We are concerned with the inconsistent application of the maturity adjustment across asset categories. In the interest of equitable treatment across institutions, we disagree with the notion that maturity adjustments should only apply to corporate assets and not to retail assets. A particular problem arises when exposures to Small- and Medium-Sized Entities ("SME") are transferred to the retail category. The SME exposures would then be treated with the lower correlations appropriate for their level of systematic risk while the maturity adjustment would, paradoxically, no longer apply. In order for the model to be equitable across banks with different business mixes, it is essential that both retail and commercial capital models include a maturity effect.

Retail Exposures

We support the introduction of separate risk-weighting curves for mortgages, revolving credits and non-mortgage non-revolving credits. The separate risk-weighting functions reflect important differences in correlation. Unfortunately, several concerns remain regarding the calibration of capital requirements for retail assets. Compared to the results of internal models and the industry study conducted by the RMA, the capital requirements for consumer assets under the Revised Proposal are generally higher than justified by the level of risk.

The primary flaw in the calibration is the inclusion of EL in the capital formula that we have already addressed. We would like to highlight that including EL not only distorts the absolute level of capital but also the relative levels of capital for assets of different credit quality.

The RMA study found that the levels of correlation set in the Revised Proposal are generally higher than industry correlations. For example, the correlation assumed for mortgages is approximately 150% of the median of values used by industry participants. We suggest the Committee review the correlations in light of industry evidence.

We also believe the correlations are inappropriately linked to default probabilities. The risk-weighting function assumes that asset correlations and systematic risk levels decrease as default probabilities rise. The RMA study found that this inverse relationship is not well supported. This tends to overstate the capital requirements for high-quality consumer assets. For example, the median correlation value used by the industry for high-quality secured consumer loans (i.e., PD of 1%) is approximately 4%. The correlation used in the risk-weighting function for these assets is 12.72%. The 10% floor on the LGD for mortgage portfolios is arbitrary and should be eliminated. For exposures with low LTVs and private mortgage insurance, this assumption is unreasonable. Supervisors should evaluate the appropriateness of LGD estimates in the context of Pillar 2. To the extent that low LGDs are supported by empirical data, banks should be allowed to use them in determining capital requirements.

Complexity of the Securitization Framework

We generally support the securitization framework proposed. However, we remain concerned with its overall complexity, conservatism and the burden of its implementation.

We believe the Revised Proposal should allow banks to use their internal ratings in the Supervisory Formula and IRB approaches. This is consistent with the A-IRB approach described throughout the Revised Proposal. Therefore, banks that qualify for the A-IRB approach should use internal ratings to determine risk weights, especially for credit enhancements and ABCP conduits.

We are also concerned with the requirement that the originator deduct all of a position equal to or less than K_{irb}, even though an external rating may be available that better represents the underlying risk exposure. We believe it would be more appropriate to require the originator to hold capital commensurate with that rating.

For unrated liquidity positions, we believe banks should be able to look through to the risk weights assigned to the underlying assets. The underlying assets represent the true risk of the liquidity position and should serve as a proxy in calculating the capital requirement. In addition, we believe the Revised Proposal does not appropriately recognize the risk-reducing benefits of dynamic asset quality tests, which significantly reduce the risk of funding liquidity facilities.

Counterparty Credit Risk

We are aware that the Committee is willing to reassess the method for calculating the capital charge for counterparty credit risk. The current approach that requires add-on factors for potential future exposure is inconsistent with the best practices of leading banks. It is essential that netting and exposure

diversification across risk factors be considered in determining effective exposure for derivative and foreign exchange portfolios. As the Committee proceeds with its review, we strongly encourage the members to seriously consider ISDA's proposals on the use of expected exposure profiles.

Operational Risk

We are very supportive of the Revised Proposal's requirement that banks hold capital against operational risk. We believe the AMA, which leverages the flexibility of internal methodologies in association with supervisory review, will allow for the most appropriate measurement and management of operational risk. We reiterate our stance in favor of a more principles-based approach over a prescriptive rules-based approach.

Due to the relatively small sample sizes of available data, the ability to apply the AMA on a legal-entity basis will be extremely limited. We strongly recommend the Committee work with the industry to develop a methodology for allocating operational risk capital at the legal entity or regional level. A very sensible approach would be to compute operational risk capital at the consolidated level by major line of business and risk category. The capital amounts could then be translated into factors based on gross income and applied to organizational entities within each line of business.

We are disappointed with the limited recognition of risk mitigation in the operational risk framework. The Revised Proposal allows limited benefit from insurance programs and does not recognize other legitimate risk transfer techniques that are developing in the industry (e.g., catastrophe bonds). We urge the Committee to add more flexibility in this approach by allowing banks to internally assess, subject to supervisory review, the benefits of operational risk reduction techniques.

We recognize the importance of understanding EL in managing risk, but believe expected loss should be reflected as a cost of doing business and not be subject to capital requirements. As for credit risk, capital should be held against unexpected loss ("UL") subject to Pillar 2 review.

We are pleased the Committee recognizes the importance of diversification within the operational risk framework. However, we are concerned with the phrase "high degree of confidence" used in the document to describe justification of the correlation factor. We believe the appropriateness of the correlation factor should be evaluated within the overall framework of the AMA. The statistical connotation of the word "confidence" implies a level of mathematical rigor that will be very difficult to achieve. We encourage the Committee to adopt more flexible language such as "an appropriate degree of confidence."

We understand operational risks are embedded in both credit risk and market risk. We agree these risks should continue to be included in the capital charges for credit and market risk, but hope the Committee will be more flexible in its direction to break out the operational risk components for a bank's internal operational risk databases. This differentiation will require significant effort and only yield modest benefits.

We appreciate the value in using internal data, external data, scenario analysis and qualitative adjustments in our capital allocation methodology. However, we would prefer a less prescriptive approach than the requirement that we use all of these data components. We would prefer the flexibility to use what is most appropriate for our particular situation subject to supervisory review.

Supervision (Pillar 2)

Supervision will play a very important role in the overall effectiveness of the new Accord, especially in the mitigation of implementation risk across international jurisdictions. As mentioned earlier, we appreciate the delicate balance that the Committee must maintain between the desire for consistency among countries and the risk of creating a burdensome and prescriptive approach. We believe quality and consistency is better ensured by clearly stating the principles of the overall risk-based capital requirement than by prescribing in detail the method of its calculation. The effectiveness of supervision is also best ensured by this approach. A principles-based Accord will allow supervisors to focus on the sufficiency of the capital instead of merely ensuring that the calculations, regardless of their appropriateness, have been correctly performed.

In addition, the complexity of the new rules poses a particular challenge for international banks regulated in multiple countries (Home/Host issue). We recommend the Committee adopt the principle of lead supervision, where a single regulator, usually in the bank's home country, would be responsible for the global supervision of the bank. This should enhance cooperation among regulators by requiring improved communication across borders and the delegation of responsibilities by the lead supervisor. Lead supervision would also prevent duplicate reviews of centralized models and conflicting requirements from different regulators.

Although it may be argued that detailed rules are required to ensure consistent treatment of capital across borders, we believe a principles-based approach regulated by a lead supervisor with the flexibility to approve unique aspects of the practices of individual banks will be more effective. A rules-based Accord implemented by multiple regulators with little latitude of judgment can only stunt the development and implementation of industry-wide best practices. Therefore, we ask the Committee and regulatory supervisors to encourage, as much as possible, the consistent application of principles rather than the rigid adherence to a set of rules. This, combined with the transparency of regulation and disclosure by the banks themselves, will best contribute to the effectiveness of the new capital Accord.

Excessive Disclosure Requirements (Pillar 3)

We support the Committee's position on the importance of market discipline and believe that disclosure has a very important role to play in the effective implementation of the Revised Proposal. We appreciate the steps that the Committee has taken to reduce the amount of required disclosure. Unfortunately, the disclosure requirements of the Revised Proposal are still excessive. The risk of misinterpretation of this information and the burden its distribution will place upon banks far outweigh its potential benefit.

Transparency is better achieved by the clear presentation of important information than by publication of large amounts of data. Providing data without insight is potentially dangerous and could undermine the safety and soundness of individual banks and the industry as a whole in stressed market conditions. The possibility for unintended consequences of excessive disclosures should be given greater consideration. Local regulators have the historical context and sufficient knowledge of the institution to correctly interpret this information. They are intimately familiar with the bank's corporate governance policies, control environment, portfolio content and level of diversification. Many market participants, on the other hand, lack the same depth and breadth of understanding of the institution. Even with volumes of

notes, they will struggle to assess the relative importance of the various required disclosures and perhaps draw inappropriate conclusions from the information. Rather than encouraging market discipline, the proposed volume of disclosure will slow the absorption of information by the market and increase the likelihood of inappropriate or contradictory conclusions by investors.

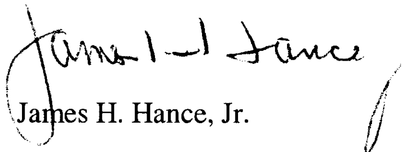
While we appreciate the desire of supervisors for uninhibited access to information, we believe corporations have a valuable role to play in summarizing and analyzing data for their shareholders. We therefore recommend the Committee, working closely with the industry and the investor community, identify a smaller subset of key disclosures that will appropriately convey a bank's risk profile without inundating the user with irrelevant information or creating the risk of misinterpretation. Remaining disclosures should be left to the judgment of each institution based on the demands of their investors, the relative importance of the information to the current financial condition of the bank and the overall economic environment.

Summary

In summary, although we generally support the Committee's approach in the Revised Proposal, we remain very concerned about the prescriptiveness of the document, the level of conservatism throughout, the limited recognition of credit mitigation techniques, and the inconsistency between the risk management methodology of the Revised Proposal and accepted practice in the industry. We fully support the addition of operational risk as it strengthens the overall capital risk methodology and aligns the regulatory capital approach with newly developed internal risk methodologies.

We would be happy to discuss our views in greater detail, or to discuss any new ideas that the regulatory authorities wish to pursue. In that regard, please contact John S. Walter, our Senior Vice President for Risk & Capital Analysis at (415) 953-0243, or Randy Shearer, our Senior Vice President, Director of Accounting Policy, at (704) 388-8433.

Sincerely,



James H. Hance, Jr.