Fleet

FleetBoston Financial

July 31, 2003

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002, Basel, Switzerland
bcbs.capital@bis.org

Re: The Proposed New Basel Capital Accord — Consultative Paper 3

Ladies and Gentlemen:

FleetBoston Financial Corporation ("FleetBoston") is the seventh largest diversified financial holding company in the United States with total assets of U.S. $197 billion. Headquartered in Boston, Massachusetts, FleetBoston has consumer and commercial banking platforms, as well as asset management and capital markets businesses, serving approximately 20 million customers worldwide.

The New Basel Capital Accord ("New Accord"), issued for comment in April 2003 as the Third Consultative Paper ("CP3"), would have a significant impact on our institution and on the banking industry in general. As such, we appreciate the opportunity to provide the Basel Committee on Banking Supervision ("Committee"), along with the US banking regulators, with our thoughts and concerns regarding the New Accord.

FleetBoston commends the Committee for the progress made since the release of the Second Consultative Paper on the New Basel Accord ("CP2") in January 2001. We believe significant improvement has been made in several areas, particularly in the calculation of minimum regulatory capital in Pillar I.

Another area where the Committee deserves commendation is for the process used to develop the details of the New Accord. We appreciate the display of openness and idea-sharing and the extent to which industry input was solicited and incorporated into CP3 in several areas. This demonstrates the Committee's desire for "getting it right."

This letter offers FleetBoston's specific comments and concerns with the rules as presented in CP3. We will concentrate on the Advanced Internal Ratings Based Approach ("AIRB") for credit risk capital and the Advanced Measurement Approach ("AMA") for operational risk capital. The U.S. supervisory agencies will be requiring us, along with several other large, internationally-active banking institutions to comply with these advanced approaches.

A Full Internal Models-Based Approach for Regulatory Capital should be adopted. FleetBoston commends the Committee for its attempt to improve upon the regulatory capital rules originally laid out in the Basel I accord. The goal of more directly linking the levels of regulatory capital with underlying economic risks is key to the New Accord's improvement and one we wholeheartedly support. Many large banks, including FleetBoston, have been managing their business for years using internal economic capital models. Drawing on our own experience, the economic capital process has proven quite successful in the management of risk, the allocation of capital, servicing our customers effectively, and improving returns to our shareholders. While CP3 is an improvement over the existing rules of Basel I, it is our strong belief that the use of the computation methods proposed by the New Accord would result in a process that falls short of achieving a truly economically-based regulatory capital methodology. We will elaborate further throughout this letter.

FleetBoston recommends that a bank's regulatory capital should be determined solely using its internal models, regardless of risk type (i.e., credit, market, and operational risks). Naturally supervisory oversight would be required. In CP3, we see pockets of reliance on internal models with the internal models-based approach for equity exposures, the existing market risk capital process, and now in the AMA for operational risk. We question why a full commitment to use of internal models is not pursued, especially in the credit risk arena. With credit risk, data and quantification techniques are well developed, yet CP3 provides a great deal of prescription that is too conservative in nature. In contrast with operational risk capital, a discipline very much in its infancy, CP3 allows for and even encourages a bank-developed AMA, and rightly so in our view.

Regulatory Capital for Expected Losses is inconsistent with Industry Practice. We believe the desire to leave the components of regulatory capital unchanged has necessitated that regulatory capital also covers expected losses. Typically, economic capital consists of common equity and is used for protection against unexpected losses only. That is, capital protects against the volatility of actual losses around the long-term average or expected level. Unfortunately, having different meanings for the term "capital" has been a barrier to effective communication about the similarities and differences between regulatory and economic capital methodologies, often leading to confusion and a lack understanding about the New Accord. Additionally, the Committee has had to incorporate "work arounds" into the New Accord (e.g., inclusion of Future Margin Income) to ensure that capital is not required where income has already been provided, through the incorporation of expected losses, to absorb losses. This adds to the complexity of the rules.

Expected losses are a recurring “cost of doing business” that are incorporated into all transaction pricing, particularly for credit products. As such, losses are then charged against income, which by its very nature includes expected loss, as incurred or via a provision to build a reserve. To require capital for expected losses seems to suggest that actual charge-offs or operating losses should be charged directly against capital, not earnings. If this were so, then banks would be freed from the need to charge these losses against earnings, as they have already set aside capital.

FleetBoston recommends that the regulatory capital methodology be revised to cover the potential for unexpected losses only. If the Committee continues to pursue the approach of covering both loss-types, then (1) all of the reserves need to be included as regulatory capital and (2) a credit to regulatory capital that reflects all of an institution’s earnings power needs to be provided (i.e., the inclusion of all the Future Margin Income needed to cover expected losses and not just the limited amount as proposed in CP3).

The New Accord is too conservative overall. First, with all the effort expended over the past five or so years by the supervisory community and the banking industry on the New Accord, it is not allowed to function as designed. The first year (90%) and second year (80%) regulatory capital floors limit the Accord's effectiveness and reduce incentives for banks to devote the resources needed to adopt the advanced approaches. We understand the need for some amount of conservatism, but not the exclusively unidirectional way in which it is applied here. We believe that these floors should be removed, allowing the methodologies in the Accord to function as intended, with regulatory capital requirements reflecting true, economic risks. If, however, the Committee decides to retain the total capital floors, then we urge that caps, similar in nature to the floors, be instituted.

Another area of concern is to what extent the results of stress tests will be factored into a bank's minimum regulatory capital levels. While they are important risk-management tools, including stress-test results in the computation of capital would result in capital levels in excess of regulatory (safe and sound) minimums. We believe this is counter to one of the New Accord's principles of linking capital more directly with the underlying economic risks to which banking firms are exposed.

Specifically, Credit Risk Capital is too conservative. We believe that the calculation of capital for credit risk includes several adjustments, which individually seem reasonable, but collectively are too conservative. Some examples include: (a) the LGDs on residential mortgages have a floor at 10%, (b) not providing the full regulatory capital benefit provided by Future Margin Income ("FMI") (e.g., only 75% for qualifying revolving retail exposures and nothing for other credit products), (c) not recognizing the full risk-reduction benefit provided by guarantees through "joint probability of default," and (d) the strict matching required for the risk reduction provided by credit default swaps.

We believe that supervisory review and validation of bank PDs, LGDs, and EADs, which is a prerequisite for the use of internal data in the regulatory capital calculations, provides enough oversight without additional minimums and maximums, which could be considered somewhat arbitrary. During the internal model certification process, concerns surrounding assumptions and data calculations should be raised and dealt with. It should not be assumed, *a priori*, that the inputs need to be made more conservative using rules-based procedures. If during the validation process examiners conclude that a bank has not shown proper back-up or sufficient justification for its inputs, supervisors can then require additional conservatism in the parameters. The advanced approach is, by its nature, the best method to assess economic risk. Arbitrarily constraining the results of such risk assessment would seem to send an unintended message to bank management. Why, for instance, would management require mortgage borrowers to have private mortgage insurance ("PMI"), a prudent risk management action, when it receives only partial regulatory capital relief?

These restrictions will continue to invite capital arbitrage, which undermines the New Accord at its inception. With regulatory capital continuing to be significantly more conservative (i.e., higher) than the economic risks would suggest, our fear is that efforts to circumvent the New Accord will continue. This is not a productive use of resources if it could be eliminated up-front by with a closer alignment of capital with the risks.

For all the reasons above, FleetBoston strongly urges the Committee to adopt the Advanced IRB approach without any specific supervisory minimums for the major inputs. It is our view that this would also motivate less-sophisticated banks to move towards a more robust risk-management framework.

A Specific Capital Charge for Operational Risks is inappropriate at this time. In general, we support the Committee’s desire to develop a methodology for operational risk capital. Our view is that the current state-of-the-art practices for operational risk measurement have not progressed sufficiently to warrant their use in the assignment of a minimum regulatory capital charge at this time.

We continue to believe that the measurement of operational risk is an emerging discipline of research that is important for the industry and its regulatory authorities and that capital should ultimately be assigned for this risk. While good progress has been made in the quantification of the risk, much important work remains before a capital charge can be determined. These tasks include:

- Collection of enough historical data of loss events to be statistically meaningful. This applies both to an individual bank's collection of its internal loss events and to the collection across the industry in total.
- Development of accurate and conceptually sound quantitative techniques needed to transform loss data into capital requirements.
- Incorporation of external loss data into individual bank capital calculation requirements with as yet unperfected methods of scaling these data to a bank's activity level, as well as for the differences in control environments.

While capital is an important component of a bank's risk management toolkit and can provide meaningful protection against unexpected operating loss events, the cost of operational risk is typically a "cost of doing business" to be covered through current period operating earnings. Banks have made a significant investment in risk mitigation costs, such as establishing and maintaining risk-control systems, internal and external audit oversight, and insurance protection. All of these form the first line of defense against the effect of operational errors and are paid for through annual earnings. With all the focus on capital that the New Accord and CP3 bring to bear, we fear that these time-tested risk mitigation and control techniques will be potentially overlooked, opening the door to significant losses.

In addition to the quantification challenges, a Pillar I capital charge does, in our view, create an uneven playing field. Products and services that are primarily operating in nature form a significant source of revenue and profit for FleetBoston through our ability to serve our customers' complete financial needs. Our fear is that a specific capital charge will put us and the global banking industry at a competitive disadvantage vis-à-vis non-bank competitors who are not subject to the same rules.

At this time, FleetBoston urges the Committee to remove the explicit capital charge for operational risk from Pillar I and to incorporate the assessment of this risk under Pillar II, Supervisory Review.

Our recommendation is not without precedent. The assessment of structural interest rate risk (i.e., that which resides in the basic banking book) has been around much longer than operational risk and has been the explicit cause of a number of bank failures in the past. The measurement processes are very well-developed and have undergone extensive scrutiny by the industry, supervisors, and academicians. All would agree there is some level of economic risk here, but the Committee has decided, and we strongly agree, that this risk is better handled within Pillar II unless a bank is running an extreme position.

We continue to believe in a Pillar II approach for now. If, however, the Committee decides to continue with a Pillar I capital charge for operational risk, the AMA approach appears to be a workable solution. Allowing a bank to use its internally-developed data and models, with regulatory oversight of course, will generate a more accurate representation of the underlying risks, which will in turn result in a more accurate level of regulatory capital. Additionally, we feel that an AMA affords the desired flexibility, including the reduction in risk afforded by insurance, and lack of prescriptiveness needed at this stage of development. Forcing banks to use a particular approach when industry, market, and supervisory "best practices" are still very much in the development phase would be a mistake. At this stage in the development of operational risk measurement, supervisors need to encourage the creation of multiple innovative techniques, which we believe the AMA allows.

We understand the dilemma with which the Committee is faced, balancing standardization of rules to foster comparability versus recognizing differences to allow for flexibility. The AMA provides ultimate flexibility but is lacking guidance on how an examiner is going to determine if a bank's process is certified for use as an AMA. This key issue requires additional direction.

In any event, FleetBoston urges continued collaboration between the industry and the bank regulatory authorities in advancing risk assessment techniques for operational risk.

The Benefit of Line-of-Business diversification is ignored. Nowhere in the New Accord is there a capital benefit provided to banks that operate a diverse mix of businesses. Business-line diversification, or alternatively risk-type diversification, mitigates both the possibility and magnitude of unexpected loss, and as a result, banks should be allowed a capital credit or risk-weighted asset reduction in recognition of such diversification. For a well-diversified institution, there is a decreased probability of a bank experiencing significant losses in each of its businesses simultaneously. For example, the New Accord would determine capital for a bank operating only two business lines — let's say consumer banking (primarily a credit-risk activity) and asset management (primarily an operational-risk activity) — as the simple addition of credit-risk capital and operational-risk capital, computed independently. We feel this overstates the institution’s total risk and as a result, the amount of regulatory capital required. In addition, ignoring the benefit sends an inappropriate message that diversification of risk provides no capital benefit, which we believe is incorrect.

We offer two examples in support of this benefit of risk diversification. First, banks consider this benefit in their economic capital models. FleetBoston has developed internal estimates of the capital reduction that comes from its existing mix of businesses. The results demonstrate that business-line diversification allows FleetBoston to reduce its economic capital from the levels that would result from the simple addition of the stand-alone capital needed for each business. JP Morgan Chase publicly discloses a capital-reduction benefit from diversification of about 16%.[1] We are not suggesting the appropriate level of diversification benefit (that would be determined by an individual bank's business mix and risk profile). Instead, we are attempting to point out that banks recognize its value in their economic capital models and in the management of capital.

Second, in our informal discussions with external rating agencies, they acknowledge that diversification is an inherent risk mitigant and is reflected in their ratings of financial institutions. For example, monoline credit card companies are viewed as riskier than well-diversified financial institutions, all else being equal. This can clearly be seen in the higher levels of capital required by the markets for concentrated businesses.

FleetBoston strongly suggests that any final rule must include a reduction in regulatory capital for the benefit of line-of-business diversification, at the total bank level.

The following example provides a simple approach on how the benefits might be computed using a sliding scale and the businesses outlined in the operational-risk proposal.

> In the consultative document, there are eight Level-1 business units.[2] To qualify for any decrease, an institution must first have at least two business units that each contributes at least 10% of the bank’s annual pre-tax net income. This would set a base reduction in the amount of 6% of the aggregate regulatory capital requirement. For each additional business that contributes

[1] JP Morgan Chase 2002 Annual Report, page 41.
[2] Annex 6, page 199, *Consultative Document — The New Basel Capital Accord*, April 2003

at least 10% of annual pre-tax net income, an extra 1% reduction in regulatory capital would be provided. Therefore, a monoline bank receives no diversification benefit, while those with two to eight businesses can have total regulatory capital reduced by an amount ranging from 6% to 12%. While conservative correlations of 0.75 were assumed in creating the preceding example, it is meant to suggest a framework to quantify a benefit we feel is warranted and meaningful.

CP3 Potentially Results in an Uneven Competitive Playing Field. As with the current regulatory capital rules, the New Accord applies only to banking firms. This would leave non-bank competitors free to pursue their business activities unencumbered by supervisory capital rules. We feel this will result in assets or businesses flowing from the banking system to entities without these capital regulations. This hurts a bank's earnings potential, making them more susceptible to economic downturns. We have heard arguments, especially in the U.S., that banks have advantages (e.g., access to discount window borrowings in time of liquidity stress) that are paid for through strict regulation. In spite of this, national banking regulators need to be aware of unintended consequences. For example, with the potential for so many activities to be conducted outside the banking system, the ability of national regulators and central banks to control systemic risks is greatly reduced, which could pose threats to the stability of national, as well as global, financial systems.

Another potentially adverse competitive element of the New Accord relates to interpretations. It appears that supervisors in each country are allowed wide discretion to interpret the New Accord as they see fit. This could provide banks in a particular country operating under a more favorable interpretation of the capital rules with a distinct competitive advantage. Often this is referred to as the "home / host" issue and will be a concern for all banks not just internationally active ones. For instance, a non-indigenous bank is able to attract business and customers from local banks because it is operating under a less-restrictive interpretation of the New Accord provided by its "home" regulator, which in turn allows for lower pricing on products and services. Therefore, great care needs to be taken to ensure this does not happen and that a standard and uniform interpretation of the proposed rules is used by all global regulatory agencies.

The Asset Securitization Capital calculation is unnecessarily complex. First, we welcome the Committee's approach that caps the regulatory capital requirement in situations where a bank retains first-loss exposure in a securitization of its own assets (i.e., banks as an issuer in securitizations). Any set of rules that results in more capital after a securitization than if the assets remained on a bank's balance sheet is fundamentally flawed. Securitization of assets is an important liquidity management tool for banks, since it represents funding with limited issuer event risk. We are strongly opposed to any capital rules that do not accurately reflect the economic risks and benefits of securitization.

FleetBoston's fundamental belief is that capital for securitization activities should be based on the results of a bank's own internal models and subject to regulatory review. Banks participating in these markets have devoted significant resources developing their own, economically-based models to understand the risks inherent in the pool of assets backing the securities issued to investors and retained by the firm. The bank's evaluation of economic risks is further validated by the rating agencies as both issued securities and retained interests are frequently rated. In addition, since these securities are sold in the capital markets, the issuer is able to receive further independent confirmation as to the economic risk inherent in these assets. We believe the calculation of retained economic risk should ultimately determine capital requirements.

As in other areas of the New Accord, the capital required under the proposed approach is too conservative (i.e., the capital is too high based on the underlying economic risks). This conclusion is based upon the results of a comparison of our own internal economic capital models with the results of QIS3. Also, the additional complexity required by CP3 with its "K_{irb}", "L", and "T" terms does not add incremental value to justify the additional cost. A simpler more direct approach would be to first determine K_{irb} as proposed. Then, the needed capital would be the lesser of this amount or the total retained first-loss position. Other tranches held by the bank would use the AIRB approach to calculate their risk-weighted assets.

A bank that is an investor in a securitization should be allowed to use its own internal credit models in the determination of regulatory capital, which is consistent with our earlier comment on the use of internal models. While CP3's Internal Ratings-Based Approach ("IRB") is a welcomed improvement over the current rules and a step in the right direction, we feel that it still overestimates the capital needed based on the securities' economic risk. This is another example of the unnecessary conservatism that is used in the New Accord for minimum regulatory capital calculations.

Pillar III Disclosure Requirements are unnecessary. The New Accord requires that a bank make extensive additional disclosures about its risk profile and risk management processes. These disclosure requirements are fundamentally flawed and should be dropped from the proposal for several reasons. First, the additional disclosures will not achieve the intended effect of increasing market understanding of financial institutions. The market is sufficiently well informed already as evidenced by the size of the market for debt issued by financial institutions. A financial institution transacts business daily in a variety of capital markets by raising wholesale funding, issuing debt, and providing clients with risk-management products. All of these transactions require the market to constantly assess the financial institution's creditworthiness including, but not limited to, its capital structure. Market participants have ample opportunity and resources to evaluate credit risk with the information already in hand. If the market needs more information, it will demand it. We do not believe the Committee has any unique insight into the additional information that may be required by the market to make the same credit decisions it makes today without these disclosures.

Complying with the disclosure process detailed in the New Accord would be quite burdensome and costly. Much of the information exists in formats designed for internal use and access. To translate and transmit the data would require additional staff and systems to ensure that the data is available, understandable, and current. Our biggest additional burden would be the effort and resources to ensure that the CP3 disclosures are put into the proper context of the bank's risk profile and not misinterpreted. Oftentimes, analysts or investors have limited time in which to understand changes in a company's financial position. This can force them into generic assumptions (e.g., all banks are the same) or cursory review that lead to incorrect views. For example, a simple disclosure of an increase in exposures in poor-quality PD bands may be picked up, but without consideration of mitigation techniques employed to offset this apparent increase in risk.

The disclosure requirements may also create additional securities law liabilities for financial institutions that are subject to U.S. securities laws. Capital reserves represent an implied view of future expected losses. Any required disclosure of a bank's assessment of its capital position is, by its nature, a "forward-looking statement" which private litigants could use to bring suits under U.S. securities laws with the benefit of "20/20 hindsight". While securities laws provide some safe harbors that may mitigate this risk, it cannot be eliminated. This incremental litigation liability would not accrue to financial institutions that are not subject to U.S. securities laws. Ultimately this would represent a competitive advantage for those institutions.

We also believe that forced disclosure of much of a bank's risk profile represents an unfair compromise of confidential and proprietary business intellectual property. The disclosure requirement may also result in a constriction of credit availability to less creditworthy customers. Banks using the AIRB approach, in particular, would have an added incentive to avoid extending credit to any borrower that could trigger a further disclosure of increasing risk positions.

Conclusion

These comments and those of industry trade organizations represent our best effort to assess the implications of this significant amendment to the regulatory capital rules. We commend the Committee for its efforts and trust that it will continue to take into consideration the many positive suggestions offered by the industry as it crafts the final version of the New Accord. The banking industry will willingly work with regulators to arrive at a set of economically robust capital rules that will provide the appropriate economic incentives to develop a more safe, sound, and competitive banking system.

FleetBoston is prepared to provide further input to the Committee's deliberations on this topic. Please contact Thomas Loeffler (617-434-7501 or thomas_h_loeffler@fleet.com) or William Schomburg (617-434-6158 or william_h_schomburg_iii@fleet.com) with further questions or comments.

Sincerely,

/s/ Robert C. Lamb, Jr.

Robert C. Lamb, Jr.
Executive Vice President
and Chief Financial Officer

Copied to: Basel 2003 Capital Proposal
Board of Governors of the Federal Reserve System
Mail Stop 155
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
regs.comments@federalreserve.gov

Basel 2003 Capital Proposal
Office of the Comptroller of the Currency
Mail Stop 3-6
250 E Street SW
Washington, DC 20219
basel.comments@occ.treas.gov

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
comments@fdic.gov

Mr. Eric S. Rosengren
Senior Vice President
Federal Reserve Bank of Boston
600 Atlantic Avenue
Boston, MA 02106

Mr. Douglas W. Roeder
Senior Deputy Comptroller, Large Bank Supervision
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, DC 20019

Mr. Jack Hall
Examiner in Charge
Office of the Comptroller of the Currency
c/o FleetBoston Financial Corporation
Mail Stop MA DE 10304N
100 Federal Street
Boston, MA 02110

Mr. Timothy MacDonald
Directing Examiner
Federal Reserve Bank of Boston
c/o FleetBoston Financial Corporation
Mail Stop MA DE 10304N
100 Federal Street
Boston, MA 02110