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August 19, 2003

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002, Basel, Switzerland
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Re: The Proposed New Basel Capital Accord

Ladies and Gentlemen:

The member banks of the New York Clearing House Association L.L.C. ("The Clearing House")[1] appreciate the opportunity to comment on the third consultative paper by the Basel Committee on Banking Supervision (the "Committee") concerning *The New Basel Capital Accord* ("CP3"). We strongly support the Committee's objective to create a new capital accord that accurately correlates capital with risk, and we appreciate the Committee's efforts to address many of the issues we and others raised in comments to the Committee generally and on the second consultative paper ("CP2") in mid-2001. We recognize that CP3 is a significant improvement over CP2. However, we believe that, as a general matter, CP3 does not achieve the intended objective of establishing a truly minimum capital adequacy standard and that a number of the specific elements of the capital regime proposed in CP3 still require substantial improvement. We continue to believe that a significant increase in capital requirements (which we believe would be the effect of the implementation of CP3 in its present form) is unwarranted and would have a negative impact on the banking system. Accordingly, we believe that CP3's flaws must be remedied before the new capital regime can be implemented.

[1] The member banks of The Clearing House are: Bank of America, National Association; The Bank of New York; Bank One, National Association; Citibank, N.A.; Deutsche Bank Trust Company Americas; Fleet National Bank; HSBC Bank USA; JPMorgan Chase Bank; LaSalle Bank National Association; Wachovia Bank, National Association; and Wells Fargo Bank, National Association.

Several of our member banks have submitted extensive individual comment letters on CP3 to the Committee. The comments below highlight the critical concerns identified by our member banks. In addition, as you are aware, on August 4, the United States bank regulatory agencies published three proposals (the "U.S. Proposals") developed from CP3 related to the U.S. implementation of The New Basel Capital Accord.[2] We are in the process of developing detailed comments on the U.S. Proposals, which we will provide to the Committee for its consideration.

I. General Issues

A. CP3 Does Not Represent a "True Minimum" Standard

At the outset, in The Clearing House's view, the capital requirements proposed in CP3, considered in their entirety, remain unduly conservative and fail to establish the "true minimum" standard CP3 is intended to accomplish. We understand that some degree of conservatism is necessary to ensure that the risks to individual institutions and the industry as a whole are adequately considered and addressed. However, because in a number of cases (including parameter values, formula alternatives and constraints)[3] the Committee has made quite conservative choices, the cumulative effect of these choices is an unnecessarily high standard that will result in unduly high capital requirements, both for individual institutions and the industry as a whole. The 99.9% confidence level the Committee has chosen as a reference point for measuring credit risk and operational risk is the standard required for a bank to be considered well-capitalized and does not represent a true minimum standard. In addition, the proposal does not give adequate recognition to the benefits of risk management practices that are customized to fit the particular business needs of an institution.

Consistent with the Committee's goals, Pillar 1 capital requirements should be set at a tolerable level, with Pillars 2 and 3 serving to encourage banks to maintain higher levels of capitalization. We respectfully submit that the Committee should modify key elements of the

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[2] See *Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord*, 68 *Fed. Reg.* 45900 (Aug. 4, 2003).

[3] These include limited recognition of Future Margin Income, limited recognition of collateral on certain loans, limited recognition of risk mitigation tools, minimum risk weights for certain assets and imposition of arbitrary floors and ceilings *(e.g.*, the 10% floor on the LGDs on residential mortgages).

proposed model so that the capital framework is the true minimum intended and does not detract from the effective operations of well-run banks.

B. CP3 Requirements Are Overly Prescriptive

The capital requirements for credit risk proposed in Pillar 1 are overly prescriptive and should be more principle-based. We understand that the Committee must provide a consistent framework for use across multiple jurisdictions and types of banking organizations, but we believe that the balance between such a framework and a structure that is not unnecessarily burdensome and prescriptive has not been achieved. The Committee's current proposal is so detailed and rigid that it does not accommodate many acceptable, and in some cases superior, management practices. We are concerned that the framework proposed in CP3 will be unable to adapt to, and may, in fact, discourage, continued innovation and sophistication in risk management techniques and financial products. We strongly urge the Committee to scale back the prescriptive requirements and produce more principle-based guidance instead. The prescriptive nature of CP3 results in flaws similar to those in rule-based, as opposed to principle-based, accounting.

C. Disclosure Requirements Are Excessive and Burdensome

We continue to believe that the guiding principle for imposing additional disclosure requirements on the banking system should be that such disclosure either provides a demonstrable benefit to investors or furthers a significant supervisory objective. We do not believe that the disclosure required under Pillar 3 meets either of these criteria. We appreciate that the Committee has reduced the disclosure requirements from those proposed in CP2. However, we believe that the Pillar 3 disclosure requirements are still excessive and unduly burdensome, and the potential for misinterpretation outweighs any benefit that might be derived from the extensive information required.

We believe that the breadth and depth of the additional disclosures proposed in CP3 would serve to undermine, rather than augment, market oversight of financial institutions. We understand that there is a view that there is no such thing, in terms of investor protection and market discipline, as too much disclosure. We disagree; the focus should be on truly helpful information rather than the volume of information. We are concerned that the flood of highly

technical, granular data required by Pillar 3 would hinder the absorption of important information by the market. The risk of obfuscation of relevant data and meaningful trends is significant. Much of the proposed disclosure would be useful, at most, only to the most sophisticated reader and would likely lead many investors and analysts to incorrect, incomplete or inappropriate conclusions. We are aware of no evidence that the market demands this additional disclosure, either from the banks that would be subject to CP3 or from their nonbank competitors.

In addition, the cost of creating the disclosure would outweigh significantly any benefit it may have. Much of the relevant data exists only in formats that would have to be translated for an external audience. Additional staff and systems would be required in order to ensure that the information was readily available, easily understandable, continuously updated and appropriately contextualized. We strongly encourage the Committee to reduce the scope, complexity, prescriptiveness and frequency of required disclosure in a way that improves the market's ability to understand and process the information presented.

D. International Consistency of Supervision and Home-Host Implementation Should Be Clarified

We believe that supervision must play a very important role in the overall effectiveness of the new capital regime and in mitigating the risk of inconsistent implementation across international jurisdictions. However, we believe that the Committee must provide more guidance about how national supervisors will coordinate the cross-border implementation of the new framework.[4] First, the Committee should clarify that a banking institution's home country supervisor has primary responsibility for oversight of its capital adequacy under CP3, and provide standards for host country deference to home country determinations. Second, under Pillar 2, individual national supervisors have a great deal of discretion. We are very concerned that inconsistent interpretation and implementation may have a significant competitive impact with banks in the most liberal jurisdictions gaining a major advantage. In addition, a bank subject to oversight by multiple supervisors with inconsistent interpretations of the capital

[4] We suggest only that the Committee should provide guidance regarding which supervisor's rules apply; we are not recommending that the Committee provide additional prescriptiveness in the substance of the capital rules.

requirements may find it expensive and difficult, or even impossible, to comply with all relevant requirements. We believe the implementation issues across national jurisdictions must be resolved before the new capital regime is implemented in order to maintain a level playing field and establish regulatory certainty for internationally active banks.

E. Implementation of the Operational Risk Requirements Should Be Clarified and Modified

We appreciate the Committee's efforts to address appropriately operational risk in the regulatory capital framework. We believe that this continues to be an important issue, and we applaud the Committee's efforts at coordination with industry groups and participants in this area. We recognize that management of operational risk is an important element of a sound risk management policy. However, although The Clearing House member banks do not all agree on the appropriate treatment of operational risk, they all agree that the treatment of operational risk in the CP3 capital model must be modified. We refer the Committee to the letters submitted by individual member banks for more detail on the member banks' views on the treatment of operational risk.

II. Specific Issues

A. Inclusion of an Expected Loss Component of the Capital Charge Should Be Eliminated

We continue to believe that the inclusion of an Expected Loss (EL) component of the capital charge is a conceptual flaw that should be eliminated, as it is inconsistent with accounting standards, widely accepted economic capital standards and industry practice. As we noted in our prior comment letter, dated May 31, 2001, in the case of credit and other risks, expected losses are largely covered by reserves (or absorbed by the revenue of business activities), and an additional regulatory capital charge would double count the risk of the EL exposure and result in systematic overstatements of risk and capital. As a result, businesses with higher EL, such as credit card and some consumer lending, would have punitively higher capital requirements because the predictable revenue stream of such businesses is not correspondingly valued. Including an EL component would cause a permanent divergence of regulatory and economic capital and add significant complexity to the capital framework. We strongly recommend that capital be required to cover only Unexpected Loss. If both loss types must be

covered, we urge the Committee to explore alternatives that could be more readily implemented (such as including the entire loan loss reserve and recognizing Future Margin Income). We refer the Committee to the comment letters submitted by our member banks for possible alternatives.

B. Capital Requirements for Many Retail Products Are Too High

We believe that the capital requirements for many retail products are too high. The capital requirements for retail assets under CP3, when compared to the results of internal models and an industry study conducted by The Risk Management Association, generally are higher than is justified by the level of risk. In some cases, the prescribed ranges of asset value correlation exceed industry standards by more than 50%. The retail framework set forth in CP3 is derived largely from the existing commercial framework and is not consistent with current industry risk management practice. We urge the Committee to modify its assumptions to be more in line with industry practice.

We note particularly the unduly high capital requirements for credit card loans made by institutions that apply the Advanced Internal Ratings Based ("AIRB") Approach. For Qualifying Revolving Exposures, the AIRB Approach is miscalibrated relative to the Standardized Approach, and, according to one survey by The Institute of International Finance, Inc., results in a 25-40% premium over the Standardized Approach. This is clearly an unfair outcome and we urge the Committee to recalibrate the AIRB Approach to reflect more accurately the actual economics and risk of the credit card business.

C. The Securitization Capital Framework Is Too Complex and the Capital Requirements Are Inconsistent with the Associated Retained Risks

We are concerned that the securitization capital framework is too complex and that the capital requirements do not reflect the redistribution of risks achieved in securitization transactions. This is particularly true for senior tranches for retail securitizations and liquidity facilities for asset-backed commercial paper conduits. For example, CP3's requirement that asset pools held in conduits be evaluated based on their risk exposure prior to recognition of any credit enhancement is contrary to industry and rating agency practice, where their internal ratings directly reflect the amount of the pool's credit enhancement and structural credit risk mitigants. We believe that banks that qualify for the AIRB Approach should be allowed to use their internal

ratings to determine risk weights. These internal risk ratings accurately measure a transaction's risk using, among other things, the rating agencies' independent evaluations of the risks associated with the transaction.

D. Recognition of Credit-Risk Hedging Should Be Expanded and Improved

Over the last several years, credit risk mitigation (CRM) techniques have increased significantly in precision, type, and volume, and the treatment of CRM should be expanded and improved in the new regulatory capital framework. CP3 uses substitution to assess the benefits of credit risk hedging and guarantees by substituting the default probability of the guarantor for that of the borrower. There is no recognition in CP3 that, with a hedged exposure, both the obligor and the guarantor must default before the bank will experience loss. We strongly believe that the Committee should modify the capital requirements to reflect the lower risk of joint default and the greater potential of joint recovery where CRM techniques are employed.

In addition, CP3 gives banks more credit for transactions secured by financial collateral than those that are secured by guarantees or supported by insurance. We do not believe there is a rational economic basis for this blanket distinction.

We also believe that the overly conservative rules on maturity mismatches should be revised. The proportional adjustment mechanism is much more conservative than the maturity treatment for corporate exposures, which we believe is unnecessary and inappropriate. In addition, the prohibition of capital relief for hedges with a maturity of less than one year when the maturity of the hedged asset is greater than one year should be eliminated. It is our view that these hedges continue to be valid risk-reducing instruments in the last year of the hedge, and capital relief for these instruments should be provided.

E. Maturity Adjustments Are Too Limited

We support the inclusion of a maturity adjustment in the risk-weighting formula to differentiate risks of loans with varying maturities. However, the rules applicable to the maturity adjustment for transactions with maturities below one year and above five years are too constricting and the calibration of the adjustment is too conservative, which ignores the different

risk attributes with maturities outside of this range. We believe that these restrictions should be removed and a fully matched maturity scale should be adopted. For transactions with an effective maturity of less than one year, the maturity adjustment should be based on an adjustment to the probability of default for the remaining term. This approach would be consistent with industry practice and sound risk management policies.

F. Benefit of Diversification Is Not Adequately Recognized

Under CP3, the benefits of diversification of business lines, asset classes, geographic regions and risk types is not adequately recognized in assessing capital requirements. This is in contrast to modern economic theory, industry practice and empirical evidence. Diversification mitigates the possibility and extent of loss by allowing holding companies to rely on earnings from one area when another area slows or experiences losses and to benefit from diversification of risk. Diversification also allows strength in market or credit performance in some areas to offset weaknesses or problems in others without necessarily drawing on capital. The regulatory capital requirements should reflect the benefits of diversification.

G. Insurance Subsidiaries Should Not Be Deconsolidated

The deconsolidation of insurance subsidiaries is inconsistent with the consolidation of securities and other financial subsidiaries under CP3. The deconsolidation approach of CP3 effectively ignores the critical role of supervisory review. Furthermore, deconsolidation would encourage arbitrage across insurance and banking entities, as entities may have an incentive to move assets receiving different capital treatment under bank risk standards and insurance risk standards into the least restrictive supervisory situations.

H. Methodology for Evaluating Counterparty Risk Should Be Improved

We encourage the Committee to revise the methodology applicable to counterparty credit exposures. The current approach is inconsistent with leading industry practice, and we urge the Committee to consider industry practice as it reviews and revises the method for calculating the capital charge for counterparty credit risk.

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The Clearing House appreciates the opportunity to comment on CP3, and we will send a copy of our comments on the U.S. Proposals we submit to the U.S. bank regulators to the Committee for its consideration. If the Committee would like additional information regarding these comments, please contact Norman R. Nelson, General Counsel of The Clearing House, at (212) 612-9205.

Sincerely,

cc: Basel 2003 Capital Proposal
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