Deutsche Bank

Deutsche Bank AG New York
Legal Department
60 Wall Street
New York, NY 10005

Tel 212 250 2500

February 1, 2007

Re: **Comment on Basel II Joint Notice of Proposed Rulemaking – Board Docket No. R-1261; OCC Docket No. 06-09; FDIC RIN 3064-AC73; OTS No. 2006-33**

Jennifer J. Johnson, Secretary
Board of Governors
of the Federal Reserve System
20th Street & Constitution Ave, NW
Washington, D.C. 20551

Robert E. Feldman
Executive Secretary, Attn: Comments
Federal Deposit Insurance Corp
550 17th Street, NW
Washington, D.C. 20429

Office of the Comptroller
of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, D.C. 20219

Regulation Comments, Attn: 2006-33
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, D.C. 20052

Ladies and Gentlemen:

Deutsche Bank appreciates the opportunity to comment on the Joint Notice of Proposed Rulemaking that implements the Basel II Capital Accord ("**Basel II NPR**").[1] In order to communicate effectively its major concerns to the agencies while providing supporting technical detail, Deutsche Bank has divided its comments between this letter and a more detailed Supplemental Memorandum attached as Appendix A hereto.

Deutsche Bank strongly supports the fundamental objective of Basel II, which is to "strengthen the soundness and stability of the international banking system" by introducing "more risk-sensitive capital requirements" based on a bank's own "internal ratings and default and loss estimates" that are actually used by management in their day-to-day "credit approval, risk management, internal capital allocations, and corporate governance functions."[2] Indeed, Deutsche Bank has collected the necessary internal data and developed the necessary internal models to report its worldwide capital ratios in accordance with the internal ratings-based approach for credit risk ("**Basel II Advanced Approach for Credit**

[1] 71 Fed. Reg. 55830 (Sep. 25, 2006).

[2] Basel II Capital Accord at 2 and 98 (¶¶ 4, 5, 6 and 444).

Risk") and the advanced measurement approach for operational risk ("**Basel II Advanced Approach for Operational Risk**" and together with the Basel II Advanced Approach for Credit Risk, "**Basel II Advanced Approaches**").

Deutsche Bank also strongly supports giving U.S. insured depository institutions ("**DIs**") and bank holding companies ("**BHCs**") the same option to report their capital ratios under the Basel II Advanced Approaches. But because of certain differences between the Basel II NPR and the Basel II Capital Accord, Deutsche Bank respectfully submits that the Basel II NPR will impose unfair burdens and impossible or conflicting requirements on

- certain foreign banking organizations ("**FBOs**")[3] that are already required to report their worldwide capital ratios under the Basel II Advanced Approaches as implemented by home country laws or regulations ("**Home Country Advanced Approaches**"); and

- DIs and BHCs that become "core banks" as a result of industry consolidation.

To eliminate these unfair burdens and impossible or conflicting requirements, Deutsche Bank respectfully submits that the Basel II NPR should be revised as follows:

1. **Traditional Authority for Discretionary Exemptions**. At a minimum, the final rule should give Federal banking supervisors the authority to grant temporary or permanent exemptions from any aspect of the final rule based on the traditional standard of being *in the public interest and consistent with the purposes of the rule*. As currently proposed, the Basel II NPR would generally permit exemptions only when they are "appropriate in light of the [institution]'s asset size, level of complexity, risk profile, or scope of operations."[4]

There are many circumstances when an exemption would be in the public interest and consistent with the purposes of the rule, but may not clearly and directly be related to an institution's asset size, level of complexity, risk profile or scope of operations. For example, two DIs, which are not even close to being core banks individually and have been complying on the basis of Basel I, could become core banks as a result of organic growth, their merger or the merger of their BHC or savings and loan holding company ("**S&LHC**") parents. It may be impossible for the combined DIs or their parents to gather five to seven years of *internal* default and loss estimate data within two years of becoming core banks, as required by the Basel II Advanced Approach for Credit Risk as defined by the Basel II NPR ("**U.S. Advanced Approach for Credit Risk**"). But because that impossibility may not clearly and directly relate to their asset size, level of complexity, risk profile or scope of operations, their

[3] As used in this letter, the term FBO includes both a foreign bank with a branch, agency or commercial lending company in the United States, and any company that directly or indirectly controls such a foreign bank.

[4] 71 Fed. Reg. at 55912 (§ 1(b)(3)).

primary Federal supervisors may not have the authority to grant them an exemption, even temporarily, despite the compelling circumstances for flexibility.

Similarly, requiring the U.S. DI or BHC subsidiaries of an FBO to calculate their credit risk under the U.S. Advanced Approach for Credit Risk could under certain circumstances violate the principle of national treatment, create competitive inequalities, impose redundant burdens or even encourage foreign retaliation against U.S. BHCs and S&LHCs. For example, even if an FBO has gathered five to seven years of internal default and loss estimate data from its U.S. DI and BHC subsidiaries in order to report its worldwide capital ratios under its Home Country Advanced Approaches, it may need five to seven additional years after its top-tier U.S. BHC becomes a core bank to gather the required internal default and loss estimate data under the U.S. Advanced Approach for Credit Risk. One reason is that the Basel II NPR defines the term "default" and certain key credit risk parameters in ways that are significantly different from how they are defined in the Basel II Capital Accord and the European Capital Requirements Directive ("**European CRD**"), which implements Basel II in Europe. Another reason is that internationally active banks typically gather data from their U.S. DI and BHC subsidiaries along global business lines for worldwide reporting purposes, rather than by country or by entity, because that is how they manage risk in their day-to-day operations.[5] Such an approach is consistent with the objectives of enterprise-wide risk management encouraged by bank supervisors.[6]

It will also be impossible for the U.S. DI and BHC subsidiaries of an FBO to satisfy the "use tests" of both the Basel II Advanced Approaches as defined by the Basel II NPR ("**U.S. Advanced Approaches**") and the FBO's Home Country Advanced Approaches at the same time. The use tests of both would require the subsidiaries to use the credit and operational risk estimates required for capital reporting purposes in their day-to-day credit and operational risk management operations. One problem is that the Basel II NPR defines default and certain loss estimate parameters and operational risk loss in ways that are significantly different from how they are defined in the Basel II Capital Accord or the European CRD. Another problem is that the size and scope of the U.S. DI and BHC subsidiaries of an FBO may be too limited to produce sufficient internal operational risk data on a local basis to generate meaningful estimates of operational risk using the parent's internal operational risk model. Under these circumstances, the U.S. subsidiaries (i) can use the credit and operational risk estimates required by the FBO's Home Country Advanced Approaches or (ii) the very different credit and operational risk estimates required by the U.S. Advanced Approaches, but (iii) cannot use both at the same time in their day-to-day risk management operations. Of course, if the internal data used for capital reporting purposes is not used in an institution's day-to-day risk credit and operational risk management

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[5] *See, e.g.*, Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations*, ¶ 35 (Feb. 2006).

[6] *See, e.g., A Supervisory Perspective on Enterprise Risk Management*, Remarks by Governor Susan Schmidt Bies (Oct. 17, 2006), avail. at www.federalreserve.gov/boarddocs/speeches/2006/20061017.

operations, it will be impossible for the institution to validate the internal models that use such internal data for capital reporting purposes.

The unfairness of requiring such U.S. DI and BHC subsidiaries to gather two very different sets of internal data and the impossibility of using both sets of credit and operational risk estimates in their day-to-day credit and operational risk management operations to validate their internal models may not clearly and directly relate to their asset size, level of complexity, risk profile or scope of operations. If the unfairness does not clearly and directly relate to these factors, the institutions' primary Federal supervisors may not have the authority under the proposed rule to grant them an exemption from these conditions, even temporarily, despite compelling circumstances for relief.

In short, the Federal banking supervisors need the flexibility to grant exemptions whenever they are in the public interest and consistent with the purposes of the rule, and not merely when they are related to an institution's asset size, level of complexity, risk profile or scope of operations.

2. **Expanded Definition of Core Bank.** A BHC that falls within the proposed expanded definition of core bank, and its DI subsidiaries, should not automatically be required to calculate their capital ratios under the U.S. Advanced Approaches unless a majority of the BHC's consolidated assets are attributable to DI subsidiaries or the DI subsidiaries qualify as core banks on a combined basis. Instead, they should be required to calculate their capital ratios under the U.S. Advanced Approaches only if the Board of Governors of the Federal Reserve System (**"Board"**) determines that they intentionally structured their assets or activities to evade the requirement to calculate their capital ratios under the U.S. Advanced Approaches.

This distinction is consistent with the stated purpose of the expanded definition, which is to "recognize[] that BHCs can hold similar assets within and outside DIs" and to "reduce[] potential incentives to structure BHC assets and activities to arbitrage capital regulations."[7] If modified as we suggest, the rule would continue to prevent a BHC with, say, $249 billion in assets attributable to DI subsidiaries, and its DI subsidiaries, from escaping treatment as core banks by establishing a broker-dealer subsidiary and channeling all additional assets to that broker-dealer subsidiary. It would also preserve the Board's discretion to require any BHC and its DI subsidiaries to calculate their capital ratios under the U.S. Advanced Approaches if the BHC falls within the definition of core bank and the Board finds that the BHC and its DI subsidiaries intentionally structured their assets or activities to evade the requirement to calculate their capital ratios under the U.S. Advanced Approach.

But the rule as so modified would recognize that there is no justification for presuming that BHCs with less than a majority of their assets attributable to DI subsidiaries

[7] 71 Fed. Reg. at 55841.

have structured their assets or activities to evade the requirement to calculate capital ratios under the U.S. Advanced or otherwise to arbitrage capital regulations. Such BHCs and their DI subsidiaries have no realistic opportunity or incentive to structure their assets or activities to avoid being subject to Basel II or otherwise to arbitrage capital regulations. Their allocation of assets between DI and non-DI subsidiaries almost always reflects circumstances or business objectives that have nothing to do with avoiding treatment as core banks or minimizing their regulatory capital requirements. In addition, they are the category of BHCs least likely to have anticipated being treated as core banks prior to the public release of the draft Basel II NPR in March 2006. Moreover, unless the definition is limited in this manner, the Basel II NPR will impose substantial burdens on BHCs controlled by FBOs without any reasonable prospect of imposing similar burdens on domestically controlled BHCs or similarly situated domestically controlled S&LHCs or consolidated supervised entities ("**CSEs**").[8] This would violate the principle of national treatment and the principle that similarly situated institutions should be treated similarly.

To illustrate the lack of any realistic opportunity or incentive for such a BHC and its DI subsidiaries to evade the requirement to calculate their capital ratios under the U.S. Advanced Approaches, consider the following example which reflects a realistic fact pattern discussed in more detail in the Supplemental Memorandum attached hereto. A BHC with $300 billion in assets at December 31, 2005, has only 10% of its assets attributable to U.S. DI subsidiaries and 90% attributable to U.S. broker-dealer subsidiaries. Neither the BHC nor its DI subsidiaries could possibly have anticipated being treated as core banks before the expansion of the definition in the public release of the draft Basel II NPR in March 2006. It would therefore be far-fetched to argue that its allocation of assets reflected any effort to structure its assets or activities to avoid being subject to Basel II. It would also be far-fetched in the extreme to argue that its allocation of assets reflected any effort to minimize its regulatory capital requirements. Regulatory capital arbitrage between DI and broker-dealer affiliates is virtually always a one-way street *from the broker-dealer to the DI*, and not the other way around. The reason is that the Securities and Exchange Commission's ("**SEC's**") traditional net capital rule is so punishing on illiquid assets such as loans and derivative contracts, which make up such a large portion of a BHC's balance sheet. Thus, at December 31, 2005, the median percentage of assets attributable to the DI subsidiaries of the five largest domestically controlled BHCs was 91%. Less than 10% of their median assets were attributable to their securities or other non-DI affiliates, even if those affiliates originated a much larger percentage of their assets or generated a larger percentage of their revenues.[9]

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[8] That is, an S&LHC or other non-BHC holding company that controls an SEC-registered broker-dealer that has voluntarily elected to be subject to the consolidated supervision of the SEC pursuant to SEC rule 15c3-1 (17 C.F.R. § 240.15c3-1).

[9] *See, e.g.*, J.P. Morgan Chase & Co., which reported $598 billion (50%) of assets and $14.6 billion (25%) of revenue attributable to its "Investment Bank" business segment in its annual report on Form 10-K at and for the year ended December 31, 2005 even though 91% of its assets were attributable to its U.S. DI subsidiaries (and less than 9% to its broker-dealer subsidiaries) at December 31, 2005.

Requiring BHCs that could not possibly have anticipated being treated as core banks before March 2006 to start reporting their capital ratios under the U.S. Advanced Approaches within two years after the proposed rule's effective date would also violate the principle of due process. They would not have been given adequate notice that they would be treated as core banks that would need to gather five to seven years of internal data within two years after the proposed rule's effective date.

Finally, the only BHCs that currently have less than a majority of their assets attributable to DI subsidiaries, or more than a majority of their assets attributable to broker-dealer subsidiaries, are controlled by FBOs (*e.g.*, those controlled by Barclays and Deutsche Bank). There is also no reasonable prospect that any domestically controlled BHC would have less than a majority of its assets attributable to DI subsidiaries. The only categories of domestically controlled financial institutions that have a similar percentage of assets attributable to DI and broker-dealer subsidiaries are S&LHCs and CSEs. But they have carefully structured their operations to avoid being treated as BHCs by limiting their DI subsidiaries to "grandfathered"[10] savings associations, Utah industrial banks or other DIs that are not treated as "banks" for purposes of the Bank Holding Company Act of 1956, as amended (**"BHC Act"**). These structuring options are not open to FBOs that have a U.S. branch, agency or commercial lending company subsidiary in the United States, because they are subject to the BHC Act whether or not their U.S. DI subsidiaries are limited to "grandfathered" savings associations, Utah industrial banks or other DIs that are not treated as banks for purposes of the BHC Act.

As a result of these circumstances, the proposed rule will violate the principle of national treatment at the present time unless FBO-controlled BHCs with less than a majority of their assets attributable to DIs are excused from calculating their capital ratios under the U.S. Advanced Approaches in the absence of a determination by the Board that they intentionally structured their assets or activities to evade the requirement to comply with the U.S. Advanced Approaches. The Federal banking agencies have long recognized that the principle of national treatment requires more than facially neutral laws and practices.[11] It requires equality of competitive opportunities (including equality of competitive burdens), which was described in the 1998 National Treatment Study as "a higher standard than *de jure* national treatment, based simply on identical treatment in law and regulation."[12] If facially neutral laws or "practices have a greater impact on foreign institutions than domestic, this is a denial of national treatment."[13] The proposed rule would have a substantially greater adverse impact on FBO-controlled BHCs at this time because at December 31, 2005:

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[10] That is, unitary S&LHCs that were grandfathered by the Gramm-Leach-Bliley Act of 1999 from the activities restrictions of the S&L Holding Company Act.

[11] *See, e.g.*, 12 C.F.R. § 225.90(b).

[12] Department of the Treasury, *National Treatment Study*, at 28 (1998).

[13] Statement of John P. LaWare, 1992 Fed. Res. Interp. Ltr. LEXIS 11, at 2 (Jan. 27, 1992).

- the top percentage of assets attributable to U.S. DI subsidiaries (less than 10%) of all FBO-controlled BHCs that would be treated as core banks under the Basel II NPR was substantially below the median percentage of assets attributable to DI subsidiaries (91%) of all domestically owned BHCs that would be treated as core banks under the Basel II NPR; and

- the top amounts and percentages of assets attributable to U.S. DI subsidiaries ($34 billion and less than 10%) of all FBO-controlled BHCs that would be treated as core banks under the Basel II NPR were substantially below the range of absolute amounts and percentages of assets attributable to DI subsidiaries ($53 billion to $209 billion, and 76% to 100%) of the top ten domestically controlled BHCs that would *not* be treated as core banks under the Basel II NPR.

The proposed rule would also violate the principle that similarly situated institutions should be treated similarly because at December 31, 2005 the top amount of assets attributable to U.S. DI subsidiaries ($34 billion) of all FBO-controlled BHCs that would be treated as core banks under the Basel II NPR was approximately equal to or substantially below the range of assets attributable to DI subsidiaries ($25 billion to $325 billion) of several S&LHCs and CSEs that have DI subsidiaries but would *not* be treated as core banks under the proposed rule or otherwise required to comply with Basel II on a compulsory basis.

3. **Option to Use Standardized Approach for Credit Risk.** The U.S. DI and BHC subsidiaries of an FBO should have the option to comply with U.S. minimum capital requirements based on Basel II's standardized approach for credit risk ("**Basel II Standardized Approach for Credit Risk**").

There is no competitive equality reason for requiring the U.S. DI and BHC subsidiaries of FBOs that are subject to Home Country Advanced Approaches to bear the double burden of gathering two sets of default and loss estimate data, building and validating two models for assigning internal ratings or complying with conflicting use tests under both the Basel II NPR and the FBO's Home Country Advanced Approaches. If anything, imposing this double burden and the conflicting use tests would create a substantial competitive inequality.

There is also no reason to believe that the Basel II Standardized Approach for Credit Risk would systematically result in lower risk-weighted assets or higher capital ratios than the U.S. Advanced Approach for Credit Risk. On the contrary, the U.S. Advanced Approach for Credit Risk is expected to result in lower risk-weighted assets and higher capital ratios than Basel I or the Basel II Standardized Approach for Credit Risk. That is one of the reasons why the Basel II NPR includes floors for risk-weighted assets under the U.S. Advanced Approaches.

Virtually every host country that has adopted Basel II will give the host-country DI and BHC subsidiaries of U.S. and other foreign financial institutions the option to use the

Basel II Standardized Approach for Credit Risk to calculate their risk-weighted assets to reflect credit risk. By allowing the U.S. BHC and DI subsidiaries of FBOs to rely on the Basel II Standardized Approach for Credit Risk, the Federal banking supervisors will avoid giving other host countries an excuse to impose double burdens or conflicting conditions on the host-country DI or holding company subsidiaries of U.S.-domiciled BHCs, S&LHCs or CSEs. It would also put FBOs on a level playing field with their U.S. domiciled competitors, which have the option of using the Basel II Standardized Approach for Credit Risk in the major non-U.S. financial centers in which they conduct operations.

4. **Option to Use Basic Indicator Approach or Standardized Approach for Operational Risk**. The U.S. DI and BHC subsidiaries of an FBO should have the option to comply with U.S. minimum capital requirements based on Basel II's basic indicator approach for operational risk ("**Basel II Basic Indicator Approach for Operational Risk**") or its standardized approach for operational risk ("**Basel II Standardized Approach for Operational Risk**").

A BHC or DI subsidiary that falls within the proposed definition of core bank should not automatically be required to calculate its operational risk in accordance with the Basel II Advanced Approach for Operational Risk as defined by the Basel II NPR ("**U.S. Advanced Approach for Operational Risk**"). Instead, a BHC or DI subsidiary should have the option to use the Basel II Basic Indicator Approach for Operational Risk or the Basel II Standardized Approach for Operational Risk. Similarly to the Basel II Standardized Approach for Credit Risk, the simpler approaches to operational risk measurement are expected to result in higher notional risk-weighted assets and lower capital ratios than the U.S. Advanced Approach for Operational risk. Furthermore, core banks with less than a *multiple* of $250 billion in consolidated total assets will almost never be able to produce sufficient internal operational risk data to satisfy the U.S. Advanced Approach for Operational Risk using internal operational risk models that are feasible at this time.

For example, Deutsche Bank has developed an internal model to estimate operational risk on a worldwide basis that contains 23 of the 56 possible regulatory operational loss types (corresponding to business line /event type cells). Even for these 23 loss types sufficient internal data could only be gathered for 4 loss types; the remaining 19 needed external industry consortium and commercial data to be able to build an advanced model at all - despite the fact that Deutsche Bank is one of the world's largest and most diverse international banking organizations, with approximately €992 billion in assets at December 31, 2005. In contrast, Deutsche Bank has estimated that Taunus Corporation ("**Taunus**"), its top-tier U.S. BHC with approximately $365 billion in consolidated assets, would be able to gather sufficient internal operational risk data for only 1 of these 23 group-wide loss types and would be dependent on external data for the remaining 22. In short, Taunus simply does not have the size or scope of operations to use Deutsche Bank's internal operational risk model on a local basis. Although the Basel II NPR permits core banks to fill any gaps in their internal operational risk data with external data, we believe that using external data for

22 of the 23 parameters would make the model useless as a risk management tool and convert it into a meaningless exercise in mathematical calculation.

There is also no competitive equality reason for requiring the U.S. DI and BHC subsidiaries of FBOs that are subject to Home Country Advanced Approaches to bear the double burden of gathering two sets of operational risk data, building and validating two internal operational risk models or complying with conflicting use tests under both the Basel II NPR and the FBO's Home Country Advanced Approaches. If anything, imposing this double burden and the conflicting use tests would create a substantial competitive inequality.

Virtually every host country that has adopted Basel II will give the host-country DI and BHC subsidiaries of U.S. and other foreign financial institutions the option to use the Basel II Basic Indicator Approach for Operational Risk or the Basel II Standardized Approach for Operational Risk to calculate their operational risk exposures. By allowing the U.S. BHC and DI subsidiaries of FBOs to rely on the Basel II Basic Indicator Approach for Operational Risk or the Basel II Standardized Approach for Operational Risk, the Federal banking supervisors will avoid giving other host countries an excuse to impose double burdens or conflicting conditions on the host-country DI or holding company subsidiaries of U.S.-domiciled BHCs, S&LHCs or CSEs. It would also put FBOs on a level playing field with their U.S. domiciled competitors, which have the option of using the Basel II Basic Indicator Approach for Operational Risk or the Basel II Standardized Approach for Operational Risk in the major non-U.S. financial centers in which they conduct operations.

5. Option to Use Home-Country Advanced Approaches. The U.S. DI and BHC subsidiaries of an FBO should have the option to use the U.S. capital rules to calculate their capital elements while using the FBO's Home Country Advanced Approaches to calculate their credit and operational risk[14] exposures, subject to the floors contained in the Basel II NPR.

As noted above, there is no competitive equality reason for requiring the U.S. DI and BHC subsidiaries of FBOs to bear the double burden of gathering two sets of credit and operational risk data,[15] building and validating two models for estimating credit or operational risk or complying with conflicting use tests under both the Basel II NPR and the FBO's Home Country Advanced Approaches. If anything, imposing this double burden and the conflicting use tests would create a substantial competitive inequality.

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[14] For operational risk, this means that an appropriate segment is carved out from the FBO's group-wide capital requirement and assigned to the U.S. BHC and DI subsidiaries, based upon a robust allocation mechanism which is subject to independent validation. The U.S. capital rules are then applied to this carved out operational risk capital requirement.

[15] It is also worth noting that many cross-border group-wide risks and exposures cannot be measured adequately on a country-by-country basis.

There is also no reason to be concerned that the use of Home Country Advanced Approaches will result in credit or operational risk exposures that are systematically lower than what would be produced using the U.S. Advanced Approaches, especially if the calculations are subject to the floors contained in the Basel II NPR. In addition, by allowing the U.S. BHC and DI subsidiaries of FBOs to use the FBO's Home Country Advanced Approaches to calculate their credit and operational risk exposures, the agencies will avoid giving other countries an excuse to impose double burdens or conflicting conditions on the foreign DI or holding company subsidiaries of U.S.-domiciled BHCs, S&LHCs or CSEs.

6. **Top Tier BHC**. The text of the proposed rule should clearly state that the only U.S. BHC subsidiary of an FBO that would be considered a core bank is the FBO's top-tier U.S. BHC subsidiary, and not any of its intermediate U.S. BHC subsidiaries. This concept is clearly stated in the release accompanying the text of the rule,[16] but it should be included in the text of the rule itself to avoid any uncertainty.

7. **Retain SR 01-01**. Finally, we believe that the Board should retain SR 01-01. That SR letter exempts a top-tier BHC controlled by an FBO from complying with the Board's minimum capital requirements otherwise applicable to U.S. BHCs, as long as its FBO parent is well-capitalized and well-managed under standards that are comparable to those of U.S. banks controlled by financial holding companies. SR 01-01 was adopted to ensure consistency with principles of national treatment, effectively giving FBOs the same ability that U.S. banking organizations have to net gains and losses in different U.S.-based subsidiaries for purposes of calculating U.S. federal tax liabilities. The Board does not exempt the top-tier BHC from its capital reporting requirements, so the policy does not compromise the Board's ability to supervise an FBO's U.S. operations.

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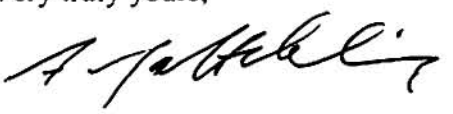
[16] Id. at 55841.

Deutsche Bank appreciates the opportunity to comment on the Basel II NPR. Please do not hesitate to contact Michael Kadish of Deutsche Bank Americas Legal (tel: 212-250-5081) or Randall Guynn at Davis Polk & Wardwell (tel: 212-450-4239) should you have any questions about this letter or the attached Supplemental Memorandum.

Very truly yours,



Dr. Andreas Gottschling
Managing Director and
Global Head of Risk Analytics and Instruments

cc: Dr. Hugo Banziger
CRO, Member of the Management Board, Deutsche Bank A.G.

Seth Waugh
CEO, Deutsche Bank Americas

Richard H. Walker
General Counsel, Deutsche Bank A.G.

Robert Khuzami
General Counsel, Deutsche Bank Americas

Scott Bowen
CFO, Deutsche Bank Americas

Richard Ferguson
Treasurer, Deutsche Bank Americas

Dr. Sebastian Fritz-Morgenthal
Global Head of Operational Risk Management, Deutsche Bank AG

Michael Kadish
Director and Senior Counsel, Deutsche Bank Americas

Appendix A

Supplemental Memorandum to Deutsche Bank's Comment Letter

This supplemental memorandum explains in greater detail the basis for Deutsche Bank's suggestions contained in its comment letter dated February 1, 2007, on the Basel II Joint Notice of Proposed Rulemaking[1] – Board Docket No. R-1261; OCC Docket No. 06-09; FDIC RIN 3064-AC73; OTS No. 2006-33.

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Deutsche Bank A.G. ("**Deutsche Bank**") strongly supports the fundamental objective of the Basel II Capital Accord, which is to "further strengthen the soundness and stability of the international banking system" by introducing "more risk-sensitive capital requirements" based on a bank's own "internal ratings and default and loss estimates" that are actually used by the bank's management in their day-to-day "credit approval, risk management, internal capital allocations, and corporate governance functions."[2] Indeed, Deutsche Bank has collected the necessary internal data and developed the necessary internal models to report its worldwide capital ratios in accordance with the internal ratings-based approach for credit risk ("**Basel II Advanced Approach for Credit Risk**") and the advanced measurement approach for operational risk ("**Basel II Advanced Approach for Operational Risk**" and together with the Basel II Advanced Approach for Credit Risk, "**Basel II Advanced Approaches**"), as set forth in the European Capital Requirements Directive, which implements Basel II in Europe ("**European CRD**")[3] As further implemented into German law, the European CRD requires Deutsche Bank to conduct a satisfactory parallel run (*i.e.*, reporting its worldwide, consolidated capital ratios under both Basel I[4] and Basel II) for at least four consecutive quarters starting January 1, 2007.

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[1] Joint Notice of Proposed Rulemaking ("**Basel II NPR**"), 71 Fed. Reg. 55830 (Sep. 25, 2006).

[2] Basel II Capital Accord at 2 and 98 (paragraphs 4, 5, 6 and 444). For purposes of Deutsche Bank's comment letter and this supplemental memorandum, "**Basel II Capital Accord**" or "**Basel II**" means the revised Basel capital accord entitled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Comprehensive Version June 2006) issued by the Basel Committee on Banking Supervision of the Group of 10 countries (the "**BCBS**").

[3] The European CRD is contained in Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) ("**Directive 2006/48/EC**") and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast) ("**Directive 2006/49/EC**").

[4] For purposes of Deutsche Bank's comment letter and this supplemental memorandum, "**Basel I Capital Accord**" or "**Basel I**" means the Basel capital accord entitled "International Convergence of Capital Measurement and Capital Standards" issued in July 1988 and updated to April 1998, and any relevant changes

Deutsche Bank also strongly supports giving U.S. insured depository institutions ("**DIs**") and bank holding companies ("**BHCs**") the same option to report and comply with minimum capital requirements based on the Basel II Advanced Approaches. But because of certain differences between the Basel II NPR and the Basel II Capital Accord described more fully below, Deutsche Bank respectfully submits that the Basel II NPR will impose unfair burdens and impossible or conflicting requirements on

- certain foreign banking organizations ("**FBOs**")[5] that are already required to report their worldwide capital ratios under the Basel II Advanced Approaches as implemented by home country laws or regulations ("**Home Country Advanced Approaches**"); and

- DIs and BHCs that become "core banks" as a result of industry consolidation.

To eliminate these unfair burdens and impossible or conflicting requirements, Deutsche Bank respectfully submits that the Basel II NPR should be revised as follows:

- **Traditional Authority for Discretionary Exemptions**. At a minimum, the final rule should give each Federal banking supervisor the authority to grant temporary or permanent exemptions from any aspect of the final rule based on the traditional standard of being *appropriate in the public interest and consistent with the purposes of the rule*. As currently proposed, the Basel II NPR would generally permit exemptions only when they are "appropriate in light of the [institution]'s asset size, level of complexity, risk profile, or scope of operations."[6]

- **Definition of Core Bank**. A BHC that falls within the proposed expanded definition of core bank, and its DI subsidiaries, should not automatically be required to calculate their capital ratios under the Basel II Advanced Approaches as defined by the Basel II NPR ("**U.S. Advanced Approaches**") unless a majority of the BHC's consolidated assets are attributable to DI subsidiaries or the DI subsidiaries qualify as core banks on a combined basis. Instead, they should be required to calculate their capital ratios under the U.S. Advanced Approaches only if the Board of Governors of the Federal Reserve System ("**Board**") determines that they intentionally structured their assets

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made by the "Amendment to the Capital Accord to Incorporate Market Risks" issued in January 1996 and updated to November 2005 by the Basel Committee.

[5] As used in this letter, the term FBO includes both a foreign bank with a branch, agency or commercial lending company in the United States, and any company that directly or indirectly controls such a foreign bank.

[6] 71 Fed. Reg. at 55912 (Section 1(b)(3)). Section 22(h)(2)(ii)(A)(1) of the proposed rule would also authorize the Federal banking agencies to exempt a DI or BHC from the requirement of having five years of internal operational loss event data "to address transitional situations, such as integrating a new business line." Id. at 55924.

or activities to evade the requirement to calculate their capital ratios under the U.S. Advanced Approaches.

- **Option to Use Standardized Approach for Credit Risk.** The U.S. DI and BHC subsidiaries of an FBO should have the option to comply with U.S. minimum capital requirements based on Basel II's standardized approach for credit risk (**"Basel II Standardized Approach for Credit Risk"**).

- **Option to Use Basic Indicator Approach or Standardized Approach for Operational Risk.** The U.S. DI and BHC subsidiaries of an FBO should have the option to comply with U.S. minimum capital requirements based on Basel II's basic indicator approach for operational risk (**"Basel II Basic Indicator Approach for Operational Risk"**) or its standardized approach for operational risk (**"Basel II Standardized Approach for Operational Risk"**).

- **Option to Use Home-Country Advanced Approaches for Risk-Weighted Assets and Operational Risk.** The U.S. DI and BHC subsidiaries of an FBO should have the option to use the U.S. capital rules to calculate their capital elements while using the FBO's Home Country Advanced Approaches to calculate their credit and operational risk exposures, subject to the floors contained in the Basel II NPR.

- **Top-Tier BHC.** The text of the proposed rule should clearly state that the only U.S. BHC subsidiary of an FBO that would be considered a core bank is the FBO's top-tier U.S. BHC subsidiary, and not any of its intermediate U.S. BHC subsidiaries. This concept is clearly stated in the release accompanying the text of the rule,[7] but it should be included in the text of the rule itself to avoid any uncertainty.

- **Retain SR 01-01.** Finally, we believe that the Board should retain SR 01-01. That SR letter exempts a top-tier BHC controlled by an FBO from complying with the Board's minimum capital requirements otherwise applicable to U.S. BHCs, as long as its FBO parent is well-capitalized and well-managed under standards that are comparable to those of U.S. banks controlled by financial holding companies. SR 01-01 was adopted to ensure consistency with principles of national treatment, effectively giving FBOs the same ability that U.S. banking organizations have to net gains and losses in different U.S.-based subsidiaries for purposes of calculating U.S. federal tax liabilities. The Board does not exempt the top-tier BHC from its capital reporting requirements, so the policy does not compromise the Board's ability to supervise an FBO's U.S. operations.

[7] Id. at 55841.

I. Factual Background

A. Deutsche Bank

Deutsche Bank is a large, internationally active bank organized under the laws of the Federal Republic of Germany. As a non-U.S. bank with a branch in the United States and the ultimate parent of two U.S. insured depository institutions as defined by Section 3 of the Federal Deposit Insurance Act, as amended (the "**FDIA**"), it is both a foreign banking organization ("**FBO**") for purposes of the International Banking Act of 1978, as amended (the "**IBA**") and a bank holding company ("**BHC**") for purposes of the Bank Holding Company Act of 1956, as amended (the "**BHC Act**"). It has also successfully elected to be treated as a financial holding company ("**FHC**") for purposes of the BHC Act. At December 31, 2005, Deutsche Bank had consolidated assets of approximately €992 billion.

Taunus Corporation ("**Taunus**") is Deutsche Bank's top tier U.S. bank holding company. Taunus is the 100% parent of Deutsche Bank Trust Corporation ("**DBTC**"), an intermediate bank holding company. DBTC owns 100% of the voting stock of Deutsche Bank Trust Company Americas ("**DBTCA**"), a New York chartered member bank, and 100% of the capital stock of Deutsche Bank Trust Company Delaware ("**DBTC Delaware**"), an insured nonmember bank organized under Delaware law. DBTCA and DBTC Delaware constitute all of the U.S. DI subsidiaries of Taunus.

Taunus also owns 100% of the capital stock of Deutsche Bank U.S. Financial Markets Holding Company ("**DBUSH**"). DBUSH is in turn the 100% parent of Deutsche Bank Securities, Inc. ("**DB Securities**"), a general securities broker-dealer that is registered as such with the Securities and Exchange Commission ("**SEC**").

At December 31, 2005, Taunus, its U.S. DI subsidiaries and DB Securities had consolidated assets of approximately $365 billion, $34 billion[8] and $264 billion, respectively. In addition, DBTCA (which accounts for substantially all of the assets and foreign exposure of Taunus's U.S. DI subsidiaries) had on-balance sheet foreign exposures at December 31, 2005 of less than $10 billion.

B. The Basel II NPR

The Basel II NPR proposes to treat any top-tier U.S. BHC subsidiary of a foreign bank as a "core bank" under the proposed new U.S. risk-based capital adequacy framework based on Basel II (the "**Proposed New U.S. Basel II Capital Framework**") if it:

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[8] Based on the combined total assets of DBTCA and DBTC Delaware, as reported in their Consolidated Reports of Condition and Income (FFIEC 031) at and for the year ended December 31, 2005.

- has total consolidated assets (excluding assets held by an insurance underwriting subsidiary), as reported on the most recent year-end FR Y-9C, equal to $250 billion or more;[9]

- has consolidated total on-balance sheet foreign exposure at the most recent year-end equal to $10 billion or more;[10]

- has a U.S. DI subsidiary that is required, or has elected, to use the U.S. Advanced Approaches to calculate its risk-based capital ratios;[11] or

- is a subsidiary of a BHC that uses the U.S. Advanced Approaches to calculate its risk-based capital ratios.[12]

The Basel II NPR would also treat each U.S. DI subsidiary of a U.S. BHC as a core bank if the U.S. BHC is a core bank.[13] Although the release accompanying the proposed rule in the Basel II NPR clearly states that only top-tier BHCs controlled by foreign banking organizations ("**FBO-Controlled BHCs**") would be treated as core banks,[14] the language of the proposed rule does not contain any such limitation.[15] Read literally, the proposed rule appears to treat intermediate FBO-Controlled U.S. BHCs (like DBTC) as core banks as well.

The Basel II NPR would require each U.S. BHC and U.S. DI subsidiary that is treated as a core bank to calculate and report its respective capital ratios in accordance with the Proposed New U.S. Basel II Capital Framework unless its primary Federal supervisor[16]

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[9] Basel II NPR, 71 Fed. Reg. at 55912 and 55948 (Section 1(b)(1)(i) of the Common Appendix and Section 3.f of the Board's Regulation Y Appendix).

[10] Id. at 55912. It would define total on-balance sheet foreign exposure as "total cross-border claims less claims with head office or guarantor located in another country plus redistributed guaranteed amounts to the country of head office or guarantor plus local country claims on local residents plus revaluation gains on foreign exchange and derivative products, calculated in accordance with the Federal Financial Institutions Examination Council (FFIEC) 009 Country Exposure Report)". Id. (Section 1(b)(1)(ii) of the Common Appendix).

[11] Id. at 55912 and 55948 (Section 1(b)(1)(iii) of the Common Appendix and Section 3.g of the Board's Regulation Y Appendix).

[12] Id. at 55912 (Section 1(b)(1)(iv) of the Common Appendix).

[13] Id. (Section 1(b)(1)(iv) of the Common Appendix) and 55841 ("A DI also is a core bank if it is a subsidiary of another DI or BHC that uses the advanced approaches.").

[14] Id. at 55841.

[15] See id. at 55948 (Section 3.f of the Board's Regulation Y Appendix). We do not believe that the reference to Form FR Y-9C in Section 3.f of the Board's Regulation Y Appendix is sufficient to remedy this omission.

[16] The primary Federal supervisor would be the Board in the case of Taunus, DBTC and DBTC Americas; and the FDIC in the case of DBTC Delaware.

"determines in writing that application of [this framework] is not appropriate in light of the [bank]'s [or BHC's] asset size, level of complexity, risk profile, or scope of operations."[17]

Each institution treated as a core bank would be required to adopt a written implementation plan no later than six months after the later of the effective date of the proposed final rule and the date the institution satisfies the definition of core bank.[18] The plan would have to incorporate an explicit first floor period start date no later than 36 months after the later of the effective date of the proposed final rule and the date the institution satisfies the definition of core bank.[19] The Basel II NPR would authorize the Federal supervisor for each core bank to extend the first floor period start date and would not put any explicit limits on the exercise of that authority.[20] Each core bank would also be required to conduct a satisfactory parallel run (*i.e.*, calculation and reporting of its capital ratios under both Basel I and Basel II) for at least four consecutive quarters before the start of the first floor period (*i.e.*, starting within 24 months after the effective date of the final rule or such later date authorized by the core bank's primary Federal supervision).[21]

The Basel II NPR would require the systems and processes used by a core bank to calculate and report its capital ratios under the U.S. Advanced Approaches to "be consistent with the [bank]'s internal risk management processes and management information reporting systems."[22] It would condition a core bank's ability to use the Basel II Advanced Approach for Credit Risk as defined by the Basel II NPR ("**U.S. Advanced Approach for Credit Risk**") on having a specified amount of historical data for certain key credit risk parameters (i.e., probability of default ("**PD**"), expected loss given default ("**ELGD**"), loss given default ("**LGD**") and exposure at default ("**EAD**")) based on the definition of "default" in the proposed rule.[23] It would require at least 5 years of default data for PD estimates, 7 years of loss severity data for ELGD and LGD estimates for wholesale exposures (5 years for retail) and 7 years of exposure amount data for EAD estimates for wholesale exposures (5 years for retail).[24]

The Basel II NPR would similarly condition a core bank's ability to use the Basel II Advanced Approach for Operational Risk as defined by the Basel II NPR ("**U.S. Advanced**

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[17] Basel II NPR, 71 Fed. Reg. at 55912 (Section 1(b)(3) of the Common Appendix).

[18] Id. at 55921 (Section 21(a)(1) of the Common Appendix).

[19] Id. at 55921-55922 (Section 21(a)(1) of the Common Appendix).

[20] Id. at 55922 (Section 21(a)(1) of the Common Appendix).

[21] Id. (Section 21(c) of the Common Appendix).

[22] Id. at 55923 (Section 22(a)(2) of the Common Appendix).

[23] Id. (Section 22(c)(6) of the Common Appendix).

[24] Id. (Section 22(c)(4) of the Common Appendix).

Approach for Operational Risk") on having "an historical observation period of at least five years for internal operational loss event data (or such shorter period approved by [the core bank's primary Federal supervisor] to address transitional situations, such as integrating a new business line).[25]

In short, if the proposed new definition of core bank contained in the Basel II NPR is retained in the final rule, Taunus and each of its U.S. DI subsidiaries will be treated as core banks, required to calculate and report their respective risk-based capital ratios in accordance with the U.S. Advanced Approaches within 24 months after the effective date of the final rule, unless their respective primary Federal supervisor grants an exemption from this requirement.

Prior to the public release of the Draft Basel II NPR on March 30, 2006,[26] there had been no suggestion that Taunus or any of its U.S. DI subsidiaries would be treated as core banks. Instead, they had every reason to believe that they would only be expected to continue calculating and reporting their risk-based capital ratios under the current U.S. capital framework based on Basel I (the "**Current U.S. Basel I Framework**"). As stated in the Draft Basel II NPR:

> "The proposed BHC consolidated asset threshold is different from the threshold in the [advance notice of proposed rulemaking ("**ANPR**") published on August 4, 2003], which applied to the total consolidated DI assets of a BHC. The proposed shift to total consolidated assets (excluding assets held by an insurance underwriting subsidiary) recognizes that BHCs can hold similar assets within and outside of DIs and reduces potential incentives to structure BHC assets and activities to arbitrage capital regulations."[27]

Indeed, the ANPR had limited the definition of "core bank" to U.S. DIs that have:

> "(1) total commercial bank (and thrift) assets of $250 billion or more, as reported on year-end [Call Reports or Thrift Financial Reports] (with banking assets of consolidated groups aggregated at the U.S. bank holding company level); or (2) total on-balance-sheet foreign exposure of $10 billion or more, as reported on the year-end Country Exposure Report (FFIEC 009) (with foreign exposure of consolidated groups aggregated at the U.S. bank holding company level)."[28]

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[25] Id. at 55924 (Section 22(h)(2)(ii)(A)(*1*) of the Common Appendix).

[26] Draft Notice of Proposed Rulemaking ("**Draft Basel II NPR**"), made available to the public by the Board on March 30, 2006.

[27] Id. at 91.

[28] ANPR at 15-16.

C. Selected Differences Between the Basel II NPR and the Basel Capital Accord and the European CRD

The Basel II NPR defines the term "default", certain key credit risk parameters and certain operational risk parameters in ways that differ significantly from they way that are defined in the Basel II Capital Accord and the European CRD.

1. Default

For example, the Basel II Capital Accord defines the term "default" in relevant part, as follows:

> "A default is considered to have occurred with regard to a particular obligor when either or both of the following events have taken place. The bank considers that the obligor is unlikely to pay its credit obligations to the banking group in full, without recourse by the bank to actions such as realizing security (if held). The obligor is past due more than 90 days on any material credit obligation to the banking group. . . . In the case of retail and [public sector entity ("**PSE**")] obligations, for the 90 days figure, a supervisor may substitute a figure up to 180 days for different products, as it considers appropriate to local conditions. In one member country, local conditions make it appropriate to use a figure of up to 180 days also for lending by its banks to corporates; this applies for a transitional period of 5 years."[29]

> ". . . The elements to be taken as indications of unlikeliness to pay include . . . [t]he bank sells the credit obligation at a material credit-related economic loss."[30]

Consistent with this definition, the European CRD defines the term "default" as follows:

> "A 'default' shall be considered to have occurred with regard to a particular obligor when either or both of the . . . following events has taken place: (a) the credit institution considers that the obligor is unlikely to pay its credit obligations to the credit institution, the parent undertaking or any of its subsidiaries in full, without recourse by the credit institution to actions such as realizing security (if held); (b) the obligor is past due more than 90 days on any material credit obligation to the credit institution, the parent undertaking or any of its subsidiaries."[31]

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[29] Basel II Capital Accord at 100 and note 89 (paragraph 452).

[30] Id. (paragraph 453).

[31] Directive 2006/49/EC at 113 (Annex VII, Part 4, point 44(b)).

". . . In the case of retail exposures and exposures to public sector entities (PSE) the competent authorities . . . of each Member State shall set the exact number of days past due that all credit institutions in its jurisdiction shall abide by under the definition of default set out in point 44, for exposures to such counterparts situated within this Member State. The specific number shall fall within 90-180 days and may differ across product lines. For exposures to such counterparts situated in the territories of other Member States, the competent authorities shall set a number of days past due which is not higher than the number set by the competent authority of the respective Member State."[32]

". . . Until 31 December 2001, for corporate exposures, the competent authorities of each Member State may set the number of days past due that all credit institutions in its jurisdiction shall abide by under the definition of 'default' set out in Annex VII, Part 4, point 44 for exposures to such counterparts situated within this Member State. The specific number shall fall within 90- up to a figure of 180 days if local conditions make it appropriate. For exposures to such counterparts situated in the territories of other Member States, the competent authorities shall set a number of days past due which is not higher than the number set by the competent authority of the respective Member State."[33]

". . . In all cases, the exposure past due shall be above a threshold defined by the competent authorities and which reflects a reasonable level of risk."[34]

". . . Elements to be taken as indications of unlikeliness to pay (and thus default) shall include . . . [t]he credit institution puts the credit obligation on non-accrual status . . . [or] sells the credit obligation at a material credit-related economic loss."[35]

The Basel II NPR would depart significantly from the definition of "default" contained in the Basel II Capital Accord and the European CRD in the following respects:

- It would define default for all retail exposures (other than residential mortgages) as including exposures that are 120 days past due (180 days past due in the case of residential mortgages).[36]

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[32] Id. at 114 (Annex VII, Part 4, points 44 and 48).

[33] Id. at 55-56 (Article 154(7)).

[34] Id. at 114 (Annex VII, Part 4, point 44).

[35] Id. (Annex VII, Part 4, points 45(a) and (c)).

[36] Basel II NPR, 71 Fed. Reg. at 55913 (Section 2 of the Common Appendix – "Default").

- In contrast, both the Basel II Capital Accord and the European CRD provide national discretion to assign a greater variety of days past due between 90 and 180 to any category of retail exposures for purposes of the definition of default.

- Thus, the German past due periods for various categories of retail exposures may and almost certainly will differ from the categories and periods established by the Basel II NPR.

- It would apply to all retail and wholesale exposures, without any materiality threshold.[37]

  - In contrast, the European CRD specifically directs Member States to apply the definition of default only to "material" credit obligations and to establish a minimum threshold for purposes of implementing the concept of materiality.

  - Thus, Germany will be required to limit the definition of default to material obligations and to establish a specific threshold for purposes of implementing the concept of materiality.

- It would not define default in relation to retail exposures by explicit reference to non-accrual status or offered for sale at a material credit-related economic loss.[38]

  - In contrast, under the European CRD a retail exposure may be considered in default if it is placed on nonaccrual status or offered for sale at a material credit-related economic loss.

- It would define default for any wholesale exposure as including any wholesale exposure that "[i]ncurred a credit-related loss of 5 percent or more of the exposure's initial carrying value in connection with the sale of the exposure or the transfer of the exposure to held-for-sale, available-for-sale, trading account, or other reporting category."[39]

  - In contrast, the European CRD takes a more flexible approach to what constitutes a material credit-related loss for purposes of classifying an exposure as default.

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[37] Id. (Section 2 of the Common Appendix – "Default").

[38] Id. (Section 2 of the Common Appendix – "Default").

[39] Id. (Section 2 of the Common Appendix – "Default").

2. Key Credit Risk Parameters

a. Loss and Loss Given Default

The Basel II Capital Accord does not define loss or loss given default. The European CRD contains very general, principles-based definitions of the terms "loss" and "loss given default," as follows:

> "'loss' . . . means economic loss, including material discount effects, and material direct and indirect costs associated with collecting on the instrument."[40]

> "'loss given default (LGD)' means the ratio of the loss on an exposure due to the default of a counterparty to the amount outstanding at default."[41]

In contrast, the Basel II NPR contains a very detailed, prescriptive definition of the term "loss given default," including various floors on LGD. The following floors will result in the most significant deviations from the LGD parameters that will be established under the European CRD:

- Unless Taunus and its U.S. DI subsidiaries receive prior written approval from the Board to use their internal estimates of LGD for a particular category of wholesale or retail exposures, the proposed definition will result in a floor on LGD equal to 8% of the particular category of exposure.[42]
    - o They are unlikely to receive such approval initially because they will not have collected sufficient data to support such approval.
- The Basel II NPR would impose a floor on LGD for residential mortgage exposures (other than segments of residential mortgage exposures for which all or substantially all of the principal of each exposure is directly and unconditionally guaranteed by the full faith and credit of a sovereign entity) equal to 10% of the exposures.[43]
- It would also appear to impose a floor on LGD for hedged exposures, at least for residential mortgage exposures subject to the 10% floor discussed above (but not expressly limited thereto), equal to 10% of such exposures.[44]

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[40] Directive 2006/48/EC at 14 (Article 4(26)).

[41] Id. (Article 4(27)).

[42] See Basel II NPR, 71 Fed. Reg. at 55917-55918 (Section 2 of the Common Appendix – "Loss given default (LGD)").

[43] Id. at 55926 (Section 31(d)(3) of the Common Appendix).

[44] Id. at 55933 (Section 33(a)(3) of the Common Appendix).

b. Exposure at Default

Neither the Basel II Capital Accord nor the European CRD contains a specific definition for the term "exposure at default". Instead, they simply defer to the internal definition and estimation of that parameter by a credit institution.

In contrast, the Basel II NPR defines the term exposure at default (EAD) in part as follows:

> "If the exposure is held-to-maturity or for trading, the bank's carrying value (including net accrued but unpaid interest and fees) for the exposure less any allocated transfer risk reserve for the exposure."[45]

This definition requires completely different data fields, including for fee information, compared to what Deutsche bank has gathered pursuant to the European CRD.

3. Operational Risk Parameters

The Basel II NPR includes proposals regarding operational risk that are different, as discussed below, from the Basel II Capital Accord and the European CRD.

a. Operational Loss

The Basel II NPR requests comment as to "whether to define operational loss solely on the effect of an operational loss event on a bank's regulatory capital or to use a definition of operational that incorporates, to a greater extent, economic capital concepts."[46] The Basel II Capital Accord and the European CRD do not contain a formal definition of "operational loss". Under each of these standards, internal loss data must be mapped against loss event types and applied in the regulatory capital calculation by firms under the Basel II Advanced Approach for Operational Risk.

b. Observation Period for Operational Risk Data

The Basel II Capital Accord and the European CRD both allow a firm to implement the Basel II Advanced Approach for Operational Risk initially with only three years of historical loss data.[47] In contrast, the Basel II NPR has proposed that "a bank's operational risk data and assessment system must include a minimum historical observation period of five years of internal operational losses."[48]

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[45] Id. at 55916 (Section 2 – "Exposure at default (EAD)"-(1)(i)).

[46] Id. at 55851 (Question 19).

[47] Basel II Capital Accord at 145 (paragraph 672); Directive 2006/48/EC, Annex X, Part 3, Section 1.2.2).

[48] Basel II NPR, 71 Fed. Reg. at 55924 (Section 22(h)(iii)(A)(1)).

c. Dependence

The Basel II NPR requires that a bank's process for estimating "dependence among operational losses within and across business lines and operational loss event types" should be demonstrably "sound, robust to a variety of scenarios".[49] The failure to meet such "explicit and objective" requirements and "dependence determinations" would mean that "the bank must sum operational risk exposure estimates across units of measure to calculate its operational risk exposure."[50] There are no such requirements in the Basel II Capital Accord or the European CRD.

d. Offsets for Expected Operational Loss

According to Basel II NPR, "budgeted funds might not be sufficiently capital-like to cover EOL [Expected Operational Loss]."[51] Such concerns regarding budgeting as a method to offset EOL are specific to the Basel II NPR and cannot be found in the Basel II Capital Accord or the European CRD.

Furthermore, the Basel II NPR states that "supervisory recognition of EOL offsets will be limited to those business lines and event types with highly predictable, routine losses. Based on discussions with the industry and empirical data, highly predictable and routine losses appear to be limited to those relating to securities processing and to credit card fraud." The Basel II NPR seeks respondents views "on other business lines or event types in which highly predictable, routine losses have been observed".[52] There are no such limitations in the Basel II Capital Accord or the European CRD. From the point of view of a large, complex universal bank with sophisticated risk management processes, predictable losses could encompass all business lines and event types.

e. Operational Risk Mitigants Other than Insurance

The Basel II NPR states that "in evaluating an operational risk mitigant other than insurance," the agencies "will consider whether the operational risk mitigant covers potential operational losses in a manner equivalent to holding regulatory capital."[53] There is no such limitation on the use of operational risk mitigants in the Basel II Capital Accord or the European CRD.

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[49] Id. at 55924 (Sec. 22(h)(3)(C)).

[50] Id.

[51] Id. at 55899-900.

[52] Id. at 55900.

[53] Id. at 55947 (Common Appendix, Section 6).

II. Discussion

Deutsche Bank believes that the Basel II NPR will impose unfair burdens and impossible or conflict requirements on certain foreign banks and on DIs and BHCs that become "core banks" as a result of industry consolidation because the Basel II NPR:

- defines the term "default" and certain key credit risk parameters in ways that differ significantly from how they are defined in the Basel II Capital Accord;
- contains certain timing mismatches between how long it will reasonably take to gather the required number of years of internal credit risk data and the requirement to comply with the U.S. Advanced Approaches within two years of becoming a core bank;
- expands the definition of core bank to include all BHCs;
- requires a BHC that falls within the proposed expanded definition of core bank, and its DI subsidiaries, to calculate their credit risk exposures under the U.S. Advanced Approach for Credit Risk even if less than a majority of its assets are attributable to DI subsidiaries;
- requires all core banks to calculate their operational risk exposures under the U.S. Advanced Approach for Operational Risk even though core banks with less than a *multiple* of $250 billion in consolidated total assets will almost never be able to produce sufficient internal operational risk data to satisfy this standard using internal operational risk models that are feasible at this time; and
- generally limits the authority of the Federal banking supervisors to grant exemptions from the proposed rule when they are "appropriate in light of the [institution's] asset size, level of complexity, risk profile, or scope of operations."

To eliminate these unfair burdens and impossible or conflicting requirements, Deutsche Bank respectfully submits that the Basel II NPR should be revised as described below.

A. Expanded Authority for Discretionary Exemptions

Section 1(b)(3) of the Proposed New U.S. Basel II Capital Framework provides that a core bank "must use" the U.S. Advanced Approaches in calculating and reporting its capital ratios "unless [its primary Federal supervisor] determines in writing that" this requirement "is not appropriate in light of the [bank]'s asset size, level of complexity, risk profile, or scope of operations."[54] We respectfully submit that this authority to grant exemptions from the requirement to use the U.S. Advanced Approaches is too narrow and should be expanded to

[54] Basel II NPR, 71 Fed. Reg. at 55912 (Section 1(b)(3) of the Common Appendix).

include any circumstance in which an exemption would be *appropriate in the public interest and consistent with the purposes of the rule.*

There are many circumstances when an exemption would be in the public interest and consistent with the purposes of the rule, but may not clearly and directly be related to an institution's asset size, level of complexity, risk profile or scope of operations. In particular, the agencies should have the flexibility to grant exemptions if necessary and appropriate to further the public interest in:

- national treatment
- similar treatment for similar institutions
- minimizing regulatory overbreadth
- due process and fundamental fairness
- avoiding model validation problems
- preventing misleading public disclosure
- minimizing the use of statistically insignificant data
- preventing undue burdens.

1. New Core Banks through Industry Consolidation

One category of circumstances in which the agencies will need this additional flexibility involves DIs and BHCs that are not currently core banks, but which become core banks in the future as a result of organic growth, their merger or the merger of their BHC or savings and loan holding company ("**S&LHC**") parents. Such DIs and BHCs would not have been required to calculate and report their capital ratios under the U.S Advanced Approaches before becoming core banks. They may not have gathered the required 5-7 years of *internal* data or built the necessary internal ratings model by the time they become core banks and may be unable to do so within 24 months of becoming core banks, especially if they become core banks as a result of an unanticipated merger or acquisition or a surge in organic growth. Even if both constituents to a merger gathered the necessary data in anticipation of a potential merger, it may not be possible to integrate the two sets of data within 24 months of the combined group becoming a core bank. Instead, it could take them up to 5-7 years after becoming a core bank to gather the required internal data and validate their internal ratings model in order to start a successful parallel run.

The threat that any DI or BHC with less than $250 billion in assets would become a core bank if it acquires or merges with or into another DI or BHC, including a relatively small DI or BHC, without any realistic possibility for relief from the requirement to start a parallel run under the U.S. Advanced Approaches within 24 months of becoming a core

bank, could distort the market for bank mergers and acquisitions. The threat could become an effective takeover defense for some institutions under certain circumstances. It could create a competitive disadvantage for any DI or BHC with less than $250 billion in assets, if it would not be able to gather the required 5-7 years of necessary data within 24 months of becoming a core bank through merger or acquisition. Conversely, it could create a huge competitive advantage for the mega banks, which would already have gathered the required data and built the necessary systems to comply with the U.S. Advanced Approaches.

Under at least some of these future circumstances, the relevant Federal supervisors may find it appropriate in the public interest and consistent with the purposes of the proposed rule to grant the relevant DIs or BHCs a temporary exemption from starting the parallel run within 24 months of becoming a core bank. They might find it appropriate to extend the transition period for up to 5-7 years in order for the new core bank to gather the required internal data and validate its internal ratings model. But they may not have the authority to do so under the proposed rule because there may be nothing about the asset size, level of complexity, risk profile or scope of operations of the particular DIs or BHCs that would justify treating them differently from other core banks. As a result, unless the authority to grant exemptions is expanded to include any circumstance that may be appropriate in the public interest and consistent with the purposes of the proposed rule, the agencies may not have the authority to grant even a temporary exemption under such circumstances.

2. Foreign Banks

Similarly, requiring the U.S. DI or BHC subsidiaries of an FBO to calculate their credit risk under the U.S. Advanced Approach for Credit Risk could under certain circumstances violate the principle of national treatment, create competitive inequalities, impose redundant burdens or even encourage foreign retaliation against U.S. BHCs and S&LHCs. For example, even if an FBO has gathered five to seven years of internal default and loss estimate data from its U.S. DI and BHC subsidiaries in order to report its worldwide capital ratios under its Home Country Advanced Approaches, it may need five to seven additional years after its top-tier U.S. BHC becomes a core bank to gather the required internal default and loss estimate data under the U.S. Advanced Approach for Credit Risk. One reason is that the Basel II NPR defines the term "default" and certain key credit risk parameters in ways that are significantly different from how they are defined in the Basel II Capital Accord and the European Capital Requirements Directive ("**European CRD**"), which implements Basel II in Europe. Another reason is that internationally active banks typically gather data from their U.S. DI and BHC subsidiaries along global business lines for worldwide reporting purposes, rather than by country or by entity, because that is how they

manage risk in their day-to-day operations.[55] Such an approach is consistent with the objectives of enterprise-wide risk management encouraged by bank supervisors.[56]

It will also be impossible for the U.S. DI and BHC subsidiaries of an FBO to satisfy the "use tests" of both the Basel II Advanced Approaches as defined by the Basel II NPR (**"U.S. Advanced Approaches"**) and the foreign parent's Home Country Advanced Approaches at the same time. The use tests of both would require the subsidiaries to use the credit and operational risk estimates required for capital reporting purposes in their day-to-day credit and operational risk management operations. One problem is that the Basel II NPR defines default and certain loss estimate parameters and operational risk parameters in ways that are significantly different from how they are defined in the Basel II Capital Accord or the European CRD. Another problem is that the size and scope of the U.S. DI and BHC subsidiaries of an FBO may be too limited to produce sufficient internal operational risk data on a local basis to generate meaningful estimates of operational risk using the parent's internal operational risk model. Under these circumstances, the U.S. subsidiaries (i) can use the credit and operational risk estimates required by the foreign parent's Home Country Advanced Approaches or (ii) the very different credit and operational risk estimates required by the U.S. Advanced Approaches, but (iii) cannot use both at the same time in their day-to-day risk management operations. Of course, if the internal data used for capital reporting purposes is not used in an institution's day-to-day risk credit and operational risk management operations, it will be impossible for the institution to validate the internal models that use such internal data for capital reporting purposes.

The unfairness of requiring such U.S. DI and BHC subsidiaries to gather two very different sets of internal data and the impossibility of using both sets of credit and operational risk estimates in their day-to-day credit and operational risk management operations to validate their internal models may not clearly and directly relate to their asset size, level of complexity, risk profile or scope of operations. If the unfairness does not clearly and directly relate to these factors, the institutions' primary Federal supervisors may not have the authority under the proposed rule to grant them an exemption from these conditions, even temporarily, despite compelling circumstances for relief.

In short, the Federal banking supervisors need the flexibility to grant exemptions whenever they are in the public interest and consistent with the purposes of the rule, and not merely when they are related to an institution's asset size, level of complexity, risk profile or scope of operations.

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[55] *See, e.g.*, Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations*, ¶ 35 (Feb. 2006).

[56] *See, e.g., A Supervisory Perspective on Enterprise Risk Management*, Remarks by Governor Susan Schmidt Bies (Oct. 17, 2006), avail. at www.federalreserve.gov/boarddocs/speeches/2006/20061017.

3. FBO-Controlled BHCs Initially Treated as Core Banks

It is not even necessary to imagine future circumstances in order to make a strong case for expanded authority to grant exemptions. For the reasons stated in greater detail below, it would be fundamentally unfair and inappropriate to require any of the FBO-Controlled BHCs that would initially be treated as core banks and have not voluntarily elected to be treated as opt-in banks to calculate and report their capital ratios under the U.S. Advanced Approaches, without at least (i) giving them substantially more time to prepare than the proposed starting date for a parallel run of 24 months after the effective date of the final rule, (ii) approving the use of a reduced number of years of historical data for default, key credit risk parameters, operational risk parameters and assessment systems and (iii) giving relief from other specific requirements of the proposed new framework. The FBO-Controlled BHCs that would initially be treated as core banks under the Basel II NPR and have not voluntarily elected to be treated as opt-in banks are the U.S. BHC subsidiaries of Barclays and Deutsche Bank.[57]

- **National Treatment**. Treating these FBO-Controlled BHCs as core banks at this time would be inconsistent with the principle of national treatment.

- **Similar Treatment for Similar Institutions**. Treating these FBO-Controlled BHCs as core banks at this time would be inconsistent with the principle that similar institutions should be treated similarly.

- **Due Process and Fundamental Fairness**. It would violate the principle of due process and fundamental fairness to treat these FBO-Controlled BHCs as core banks at this time because prior to the public release of the Draft Basel II NPR on March 30, 2006, none of them reasonably expected that their U.S. subsidiaries would be treated as core banks.

- **Conflicting Use Tests**. It will be impossible for these FBO-Controlled BHCs to comply with the "use test" of the Basel II NPR while they simultaneously comply with the "use test" of their Home Country Advanced Approaches. One reason is that the Basel II NPR contains definitions of default and key credit risk parameters that are substantially different from those defined in the Basel II Capital Accord and the European CRD. Another reason is that foreign banks typically gather data from their U.S. DI and BHC subsidiaries along global business lines for worldwide reporting purposes, rather than by country or by entity, because that is how they manage risk in their day-to-day operations.

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[57] The Basel II NPR would also treat HSBC North America Holdings Inc. ("**HSBC North America**"), another FBO-Controlled BHC, as a core bank. But HSBC North America has previously indicated its desire to opt in to the U.S. Advanced Approaches voluntarily. Because its U.S. operations are largely retail in nature, we believe that the burden of complying with the U.S. Advanced Approaches may be far lighter and the benefit in terms of reduced capital for such compliance may be far more substantial than they would be for the other FBO-Controlled BHCs that would initially be treated as core banks under the Basel II NPR.

- **Misleading Public Disclosure.** The requirement that these FBO-Controlled BHCs publicly disclose their capital ratios under the U.S. Advanced Approaches would result in misleading disclosure.

- **Statistically Insignificant Data.** These FBO-Controlled BHCs may be too small to generate statistically significant operational risk data for purposes of the advanced approach for operational risk.

- **Undue Burden.** The burden of requiring these FBO-Controlled BHCs to calculate and report their capital ratios under the U.S. Advanced Approaches substantially outweighs any conceivable benefit.

Despite these compelling reasons for granting these FBO-Controlled BHCs a temporary or permanent exemption from complying with the U.S. Advanced Approaches (which are each discussed in greater detail below), they may not be clearly and directly related to the asset size, level of complexity, risk profile, or scope of operations of their U.S. BHC and DI subsidiaries. But because a temporary or permanent exemption under these circumstances would clearly be appropriate in the public interest and consistent with the purposes of the proposed rule, they illustrate why the agencies' authority to grant exemptions should be expanded.

a. National Treatment

Treating these FBO-Controlled BHCs as core banks at this time would be inconsistent with the principle of national treatment. The agencies have indicated that a rule which expressly imposes a cost or burden on the U.S. activities of foreign banks, but not on the U.S. activities of similarly situated domestic banks, would be inconsistent with the principle of national treatment.[58] The agencies have recognized that the principle of national treatment requires more than facially neutral laws and practices.[59] It requires equality of competitive opportunities (including equality of competitive burdens), which was described in the 1998 National Treatment Study as "a higher standard than *de jure* national treatment, based simply on identical treatment in law and regulation."[60] The National Treatment Studies have suggested that if facially neutral laws or "practices have a greater impact on foreign institutions than domestic, this is a denial of national treatment."[61] While this differential impact "standard . . . may be difficult for any country's laws and practices to meet, including

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[58] See 1993 Fed. Res. Interp. Ltr. LEXIS 223 (July 8, 1993) ("requiring examination fees for foreign banks but not for domestic banks . . . would be inconsistent with the principle of national treatment").

[59] Thus, the Board has frequently customized otherwise facially neutral rules to equalize the regulatory burdens placed on foreign and domestic banks. *See, e.g.*, 12 C.F.R. § 225.90(b) (which defers to home country standards in determining whether a foreign bank is well-capitalized).

[60] Department of the Treasury, *National Treatment Study*, at 28 (1998).

[61] Statement of John P. LaWare, 1992 Fed. Res. Interp. Ltr. LEXIS 11, at 2 (Jan. 27, 1992).

those of the United States,"[62] this difficulty does not excuse a rule that clearly imposes a substantial burden on FBO-Controlled U.S. BHCs without imposing a similar burden on similarly situated BHCs not controlled by FBOs ("**Domestic U.S. BHCs**"). It does not matter whether the rule expressly imposes a burden solely on FBO-Controlled U.S. BHCs or whether it is a facially neutral rule that has this effect as a practical matter.

Under these well-established standards, the proposed expanded definition of core bank would violate the principle of national treatment unless the FBO-Controlled BHCs that would initially be treated as core banks are exempted from the requirement to calculate and report their capital ratios under the U.S. Advanced Approaches, if:

- the percentage of assets attributable to the U.S. DI subsidiaries of the particular FBO-Controlled BHC is substantially below the median percentage of such assets of the Domestic BHCs that would be treated as core banks under the proposed rule; or

- the absolute amount and percentage of the U.S. DI subsidiaries of the particular FBO-Controlled BHC is substantially below the absolute amounts and percentages of such assets of a substantial number of Domestic U.S. BHCs that would not be treated as core banks under the proposed rule.

If either of these conditions exists, the proposed rule would have the effect of imposing a burden on these FBO-Controlled U.S. BHCs, without any reasonable prospect of imposing a similar burden on similarly situated Domestic BHCs.

Only 9% of the consolidated total assets of Taunus, the top-tier U.S. BHC subsidiary of Deutsche Bank, were attributable to its U.S. DI subsidiaries at December 31, 2005. Even more dramatically, only 1% of the consolidated total assets of Barclays Group US Inc. ("**Barclays US**"), the top-tier U.S. BHC subsidiary of Barclays Bank plc, a U.K. bank with consolidated assets of £924.3 billion at December 31, 2005, were attributable to its U.S. DI subsidiary at September 30, 2006. According to the Basel II NPR, there are 11 top-tier banking organizations that would be treated as core banks under the proposed expanded definition.[63] As far as Deutsche Bank can tell from the public record, seven of these top-tier banking organizations appear to be Domestic U.S. BHCs, one is a savings and loan holding company ("**S&LHC**"),[64] and three are FBO-Controlled U.S. BHCs.[65] As shown in the

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[62] Id.

[63] Basel II NPR, 71 Fed. Reg. at 55841.

[64] Based on the public record, it appears that Washington Mutual, Inc. ("**WaMu Inc.**") would be treated as a core bank on the basis of its own assets ($344 billion at December 31, 2005) or the assets attributable to its principal DI subsidiary, Washington Mutual Bank ("**WaMu Bank**"), a thrift institution which had $331 billion in assets at December 31, 2005. But because the OTS does not impose minimum capital or capital reporting requirements on S&LHCs, this will not have any impact on WaMu Inc.

[65] In addition to the top-tier U.S. BHC subsidiaries of Barclays and Deutsche Bank, the Basel II NPR would treat HSBC North America as a core bank. But as noted above, HSBC North America has previously

following table, five of these Domestic U.S. BHCs would be treated as core banks on the basis of their assets at December 31, 2005 and the median percentage of their assets attributable to their U.S. DI subsidiaries would be 91% (J.P. Morgan Chase) and the lowest percentage would be 65% (Citigroup).

Institution Name	Total Assets	Attributable to US DI Subs	% of Total
	(in billions, except percentages)		
Bank of America Corporation	$1,292	$1,235	96%
Wachovia Corporation	$521	$475	91%
JPMorgan Chase & Co.	$1,199	$1,093	**91%**
Wells Fargo & Company	$482	$428	89%
Citigroup Inc.	$1,494	$976	**65%**
Taunus Corporation	$365	***$34***	***9%***
Barclays US (1)	$321	***$4***	***1%***

(1) At September 30, 2006. Barclays US had only $216 billion, and its U.S. DI Subsidiary only $3 billion, in consolidated total assets at December 31, 2005.

Sources: Annual Reports of BHCs on Form FR Y-9C and Call Reports of U.S. DI subsidiaries at December 31, 2005 (September 30, 2006 in the case of Barclays US and its DI subsidiaries).

It appears that the two remaining Domestic U.S. BHCs that would be treated as core banks under the proposed rule would be treated as such on the basis of their on-balance-sheet foreign exposures. Because on-balance-sheet foreign exposures are generally not available to the public, it is impossible for us to confirm whether the percentages of assets attributable to the U.S. DI subsidiaries of these other Domestic BHCs follows the same pattern, but we believe that they do. For example, we believe that State Street Corporation and The Bank of New York Company, Inc. are the two other Domestic U.S. BHCs that will be treated as core banks on the basis of their on-balance-sheet foreign exposures, and the percentages of their assets attributable to their U.S. DI subsidiaries were 90% and 85%, respectively, at December 31, 2005 – essentially the same median percentage of assets attributable to their U.S. DI subsidiaries as the Domestic U.S. BHCs that are core banks based on total assets.

Similarly, as shown in the following table, there are more than a dozen additional Domestic U.S. BHCs that would not be treated as core banks under the proposed rule even though they had substantially more assets on an absolute and percentage basis attributable to their U.S. DI subsidiaries than Taunus at December 31, 2005 or Barclays US at September 30, 2006. As noted above, only $34 billion (9%) of Taunus's total consolidated assets at

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indicated its desire to opt in to the U.S. Advanced Approaches voluntarily. Because its U.S. operations are largely retail in nature, we believe that the burden of complying with the U.S. Advanced Approaches may be far lighter and the benefit in terms of reduced capital for such compliance may be far more substantial than they would be for Taunus.

year-end 2005, and $4 billion (1%) of Barclays US's consolidated total assets at September 30, 2006, were attributable to their respective U.S. DI subsidiaries.

Institution Name	Total Assets	Attributable to U.S. DI Subs	% of Total
	(in billions, except percentages)		
U.S. Bancorp	$209	$209	100%
SunTrust Banks, Inc.	$180	$178	98%
Countrywide Financial Corporation	$175	$73	42%
Citizens Financial Group, Inc.	$155	$155	100%
ABN AMRO N.A. Holding Co.	$144	$110	76%
National City Corporation	$142	$142	100%
BB&T Corporation	$109	$109	100%
Fifth Third Bancorp	$105	$105	100%
Keycorp	$93	$89	96%
PNC Financial Services Group, Inc.	$92	$86	94%
Capital One Financial Corporation	$89	$74	83%
Regions Financial Corporation	$85	$81	95%
BancWest Corporation	$66	$66	100%
North Fork Bancorporation	$58	$58	100%
Comerica Incorporated	$53	$53	100%
M&T Bank Corporation	$55	$55	99%
AmSouth Bancorporation	$53	$53	99%
Taunus Corporation	$365	***$34***	***9%***
Barclays US (1)	$321	***$4***	***1%***

(1) At September 30, 2006. Barclays US had only $216 billion, and its U.S. DI Subsidiary only $3 billion, in consolidated total assets at December 31, 2005.

Sources: Annual Reports of BHCs on Form FR Y-9C and Call Reports of U.S. DI subsidiaries at December 31, 2005 (September 30, 2006 in the case of Barclays US and its DI subsidiaries).

Although it is theoretically possible that some Domestic U.S. BHC may in the future satisfy the proposed new definition of core bank with a percentage and absolute amount of U.S. DI subsidiary assets that are substantially similar to those of Taunus and Barclays US, there is no reasonable prospect that such a circumstance will occur in the foreseeable future. As a result, the only foreseeable effect of the proposed expanded definition is to impose a burden solely on FBO-Controlled BHCs, without imposing a similar burden on any similarly situated Domestic U.S. BHCs.

As discussed more fully under Section II.A.2.h. (Undue Burdens) below, the burden that would be imposed on Taunus and Barclays US by the proposed new rule would be substantial. As more fully discussed under Section I.C.3 above, the Basel II NPR would adopt definitions of the term "default" and the key credit risk parameters (PD, ELGD, LGD, EAD) that depart significantly from the definitions in the Basel II Capital Accord and the European CRD. In addition, Barclays and Deutsche Bank have each collected their data and

developed their systems along global, cross-border business lines, rather than by country or by entity. These differences mean that it would require an immense new and duplicative commitment of resources for Barclays and Deutsche Bank to start a parallel track of collecting the necessary internal data and developing the required internal ratings model for their U.S. subsidiaries on a stand-alone basis in order for Taunus, Barclays US and their DI subsidiaries to be able to report and comply with minimum capital requirements under the U.S. Advanced Approaches.

Moreover, the Basel II NPR would condition the ability of the U.S. BHC and DI subsidiaries of Barclays and Deutsche Bank to use the advanced measurement approaches for operational risk on having at least five years of internal operational loss event data (or such shorter period approved by the their respective primary Federal supervisor for transitional purposes).[66] As more fully discussed under "Minimizing Unreliable Data" below, the U.S. BHC and DI subsidiaries of Barclays and Deutsche Bank are too small to generate statistically significant operational risk data for purposes of the advanced approach for operational risk.

There is no certainty that the U.S. BHC and DI subsidiaries of Barclays or Deutsche Bank could succeed in collecting all the necessary data or developing the systems necessary to calculate their capital ratios under the U.S. Advanced Approaches before the two-year deadline for a parallel run after the effective date of the proposed final rule.

In short, because treating the U.S. BHC and DI subsidiaries of Barclays and Deutsch Bank as core banks would impose a substantial burden on these subsidiaries, without any reasonable prospect of imposing a similar burden on any similarly situated Domestic U.S. BHC or its U.S. DI subsidiaries, such treatment would violate the principle of national treatment, unless the U.S. BHC and DI subsidiaries of Barclays and Deutsche Bank are exempted from the requirement.

b. Similar Treatment for Similar Institutions

Treating the U.S. BHC and DI subsidiaries of Barclays and Deutsche Bank as core banks at this time would also be inconsistent with the principle of treating these BHCs similarly to similarly situated domestic securities holding companies or S&LHCs. The vast majority of assets of Taunus ($264 billion or 72%) at December 31, 2005, and, we believe, of Barclays US, were attributable to their respective SEC-registered broker-dealer subsidiaries, rather than to their U.S. DI subsidiaries. As shown in the following table, however, there are at least five non-BHC securities holding companies that had substantially the same or more assets attributable to securities activities or other non-DI subsidiaries at year-end 2005, and three of the five had substantially the same ($25 and $32 billion, respectively, in the case of Morgan Stanley and Lehman Brothers) or more ($71 billion, in the case of Merrill Lynch) assets in absolute terms attributable to U.S. DI subsidiaries. Yet none of them would be treated as a core bank under the Proposed New U.S. Basel II Capital Framework or otherwise

[66] Basel II NPR, 71 Fed. Reg at 55924 (Section 22(h)(2)(ii)(A)(*1*) of the Common Appendix).

required to calculate and report its capital ratios under the U.S. Advanced Approaches on a compulsory basis. They have carefully structured their operations to avoid being treated as BHCs by limiting their DI subsidiaries to savings associations, Utah industrial banks or other DIs that are not treated as "banks" for purposes of the Bank Holding Company Act of 1956, as amended ("**BHC Act**").[67] These structuring options are not open to FBOs that have or control a foreign bank that has a U.S. branch, agency or commercial lending company subsidiary in the United States, because they are subject to the BHC Act whether or not their U.S. DI subsidiaries are limited to "grandfathered" savings associations, Utah industrial banks or other DIs that are not treated as banks for purposes of the BHC Act.

Institution Name	Total Assets	Attributable to Securities Subs	% of Total	Attributable to U.S. DI Subs	% of Total
		(in billions, except percentages)			
Merrill Lynch	$681	$304	45%	$71(3)	10%
Morgan Stanley	$899 (1)	$516 (1)	57%	$32	3%
Goldman Sachs	$707 (2)	$499 (2)	70%	N/A	N/A
Lehman Brothers	$410 (1)	$313 (1)	76%	$25	6%
Bear Stearns	$293 (1)	$192 (1)	65%	N/A	N/A
Taunus	$365	***$264***	72%	***$34***	9%

(1) At November 30, 2005, the group's fiscal year-end.
(2) At November 25, 2005, the group's fiscal year-end.
(3) On January 29, 2007, Merrill Lynch announced its intent to purchase First Republic Bank, Las Vegas, NV, which had $10 billion of assets as of September 30, 2006. Press release of First Republic Bank, http://www.firstrepublic.com/aboutus/press/release.asp?press_release_id=398.

Sources: Annual Reports of Securities Groups on Form 10-K, Consolidated Financial Statements of securities subsidiaries as provided on parent's website, and Call Reports of U.S. DI Subsidiaries at December 31, 2005, except where noted. Annual Reports of BHCs on Form FR Y-9C and Call Reports of U.S. DI subsidiaries at December 31, 2005 (September 30, 2006 in the case of First Republic Bank).

Each of these domestic securities holding companies has voluntarily elected to be treated as a consolidated supervised entity ("**CSE**") by the SEC.[68] CSEs are required to

[67] Thus, for example, when Merrill Lynch recently agreed to acquire First Republic Bank, an FDIC-insured nonmember bank which otherwise would have caused it to become a bank holding company, it announced that it was structuring the transaction so that First Republic Bank would be merged with and into Merrill Lynch Bank and Trust Co., FSB, a federal savings association. Thus, Merrill Lynch will remain an S&LHC, but will not become a BHC. *See* First Republic Bank Press Release of January 29, 2007, http://www.firstrepublic.com/aboutus/press/release.asp?press_release_id=398. Unlike BHCs, S&LHCs with more than $250 billion in consolidated total assets are not core banks for purposes of the Basel II NPR, and the OTS does not impose minimum capital or capital reporting requirements on S&LHCs.

[68] Testimony of Robert L.D. Colby, Acting Director, Division of Market Regulation, SEC Before the House Subcommittee on Financial Institutions and Consumer Credit at 2 (Sep. 14, 2006) ("**Colby Testimony**").

report their capital ratios in accordance with SEC guidelines,[69] which have been described as being based on "standards adopted by the [BCBS]."[70] But the CSE rules do not impose any minimum capital requirements and "do not specify that capital adequacy be calculated using the original framework, Basel I, or the revised framework Basel II. Likewise, the rule does not prescribe the use of the 'advanced' approaches contained in Basel II."[71] Thus, CSE's have total freedom to report under Basel I or opt in to Basel II; they are not required even to report under Basel II. In addition, because both CSE election and Basel II are entirely voluntary, the CSEs can opt out of their capital reporting requirements altogether by terminating their status as a CSE. As a result, if they report their capital ratios based on Basel II, they are more analogous to opt-in banks, which voluntarily agree to report their capital ratios in accordance with Basel II, than to core banks, which are required to report and comply with minimum capital requirements on the basis of Basel II.

Finally, there are a number of S&LHCs that had substantially more assets attributable to their U.S. DI subsidiaries at December 31, 2005 than Taunus (at December 31, 2005) or Barclays US (at September 30, 2006). Yet none of them is required even to report its consolidated capital ratios under the U.S. Advanced Approaches, much less comply with any minimum capital requirements based on them, including WaMu Inc., which had total consolidated assets of $344 billion at December 31, 2005. As explained in the Basel II NPR, the OTS, which regulates and supervises S&LHCs, "does not currently impose any explicit capital [reporting or minimum capital] requirements on savings and loan holding companies and does not propose to apply the Basel II proposal to these holding companies."[72]

In sum, because treating FBO-Controlled BHCs as core banks would impose a substantial burden on certain FBO-Controlled BHCs without imposing a similar burden on any similarly situated domestic securities holding company or S&LHC and their U.S. DI subsidiaries, it would violate the principle that similar institutions should be treated similarly, unless such FBO-Controlled BHCs are exempted from the requirement.

c. Due Process and Fundamental Fairness

Prior to the public release of the Draft Basel II NPR on March 30, 2006, Barclays and Deutsche Bank each reasonably believed that none of their U.S. subsidiaries would be required to comply with the Proposed New U.S. Basel II Capital Framework. Neither had any idea that their U.S. BHC and DI subsidiaries might be required to calculate and report

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[69] Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities ("**Alternative Net Capital Rule**"), 69 Fed. Reg. 34428, • (June 21, 2004) (adopting Rule 15c3-1 (17 C.F.R. § 240.15c3-1)).

[70] Colby Testimony at 2.

[71] Id. at 2-3.

[72] Basel II NPR, 71 Fed. Reg. at 55841, note 21.

their respective risk-based capital ratios as a "core bank" in accordance with the Proposed New U.S. Basel II Capital Framework because:

- The combined total consolidated assets of Barclay's and Deutsche Bank's U.S. DI subsidiaries, as reported in their Call Reports at December 31, 2005, was only approximately $3 billion and $34 billion, respectively; and

- The total on-balance-sheet foreign exposure of their U.S. DI subsidiaries was less than $10 billion at December 31, 2005.

No one ever suggested that the U.S. BHC or DI subsidiaries of Barclays or Deutsche Bank should participate in the QIS4. Not until the release of the Draft Basel II NPR on March 30 of this year did any FBO-Controlled BHC receive any notice that it and its U.S. DI subsidiaries would be treated as core banks.

Because this notice came so late, none of the FBO-Controlled BHCs received adequate notice that they would be treated as "core banks" under the Basel II NPR. Thus, it would be fundamentally unfair and inappropriate to require FBO-Controlled BHCs or U.S. DI subsidiaries to calculate and report their respective risk-based capital ratios in accordance with the U.S. Advanced Approaches, without at least giving them substantially more time to comply with these requirements than 24 months after the effective date of the final U.S. rule.

d. Conflicting Use Tests

It will also be impossible for the U.S. DI and BHC subsidiaries of an FBO to satisfy the "use tests" of both the U.S. Advanced Approaches and the FBO's Home Country Advanced Approaches at the same time. The use tests of both would require the subsidiaries to use the credit and operational risk estimates required for capital reporting purposes in their day-to-day credit and operational risk management operations. One problem is that the Basel II NPR defines default, certain loss estimate parameters, and operational risk loss in ways that are significantly different from how they are defined in the Basel II Capital Accord or the European CRD. Another problem is that the size and scope of the U.S. DI and BHC subsidiaries of an FBO may be too limited to produce sufficient internal operational risk data on a local basis to generate meaningful estimates of operational risk using the parent's internal operational risk model. Under these circumstances, the U.S. subsidiaries (i) can use the credit and operational risk estimates required by the foreign parent's Home Country Advanced Approaches or (ii) the very different credit and operational risk estimates required by the U.S. Advanced Approaches, but (iii) cannot use both at the same time in their day-to-day risk management operations. Of course, if the internal data used for capital reporting purposes is not used in an institution's day-to-day risk credit and operational risk management operations, it will be impossible for the institution to validate the internal models that use such internal data for capital reporting purposes.

The Basel II Capital Accord, the European CRD and the Basel II NPR all require banks to use the same key credit risk parameters in their day-to-day credit approval, risk management, internal capital allocations and corporate governance functions as they use in their internal models as a condition to using the advanced approaches. Thus, paragraph 444 of the Basel II Capital Accord contains the following "use test" as one of its conditions for using the advanced approaches:

> "Internal ratings and default and loss estimates must play an essential role in the credit approval, risk management, internal capital allocations, and corporate governance functions of banks using the IRB approach. Ratings systems and estimates designed and implemented exclusively for the purpose of qualifying for the IRB approach and used only to provide IRB inputs are not acceptable."[73]

Article 84.2(b) of Directive 2006/48/EC contains a similar "use test" as one of its conditions for using the European Advanced Approaches:

> "Internal ratings and default and loss estimates used in the calculation of capital requirements and associated systems and processes [must] play an essential role in the risk management and decision-making process, and in the credit approval, internal capital allocation and corporate governance functions of the credit institution."[74]

Section 22(a)(2) of the proposed U.S. rule contains a similar "use test" as one of its conditions for using the U.S. Advanced Approaches:

> "The systems and processes used by a [bank] for risk-based capital purposes under this [proposed rule] must be consistent with the [bank]'s internal risk management processes and management information reporting systems."[75]

These use tests reflect the understanding that the validation of the data, key credit risk and operational risk parameters and outputs of an internal credit risk model requires testing whether the outcomes predicted by the model match actual outcomes in day-to-day operations over some period of time. Unfortunately, because of significant differences between the definitions of the term "default" and certain key credit risk and operational risk parameters in the Basel II NPR and those in the European CRD summarized in Section I.C above, it will not be possible for FBO-Controlled BHCs and their U.S. DI subsidiaries to use both the U.S. definitions and their home country definitions in their day-to-day credit approval, risk management, internal capital allocations and corporate governance functions of a business at the same time. As a result, they cannot satisfy the "use tests" of both the

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[73] Basel II Capital Accord at 98.

[74] European CRD, Directive 2006/48/EC, at 35 (Article 84.2(b)).

[75] Basel II NPR, 71 Fed. Reg. at 55923 (Section 22(a)(2) of the Common Appendix).

Basel II NPR and Home Country Advanced Approaches, or validate the data, key credit and operational risk parameters and outputs of their internal models under both sets of definitions at the same time.

Many European FBOs, including Barclays and Deutsche Bank, have been preparing for several years with an immense commitment of resources, have collected the historical time series of default, loss severity and exposure amount data required by the European CRD and developed systems and processes to use them based on the European definitions of the terms "default", PD, ELGD, LGD and EAD. In some cases, they have validated 300 parameters or more.

Even assuming the U.S. BHC and DI subsidiaries of these FBOs were able to collect the required data[76] and develop the systems necessary to perform the calculations under the U.S. Advanced Approaches, the resulting ratings and default and loss estimates based on the U.S. definitions would not be able to play an essential role in the credit approval, risk management, internal capital allocations, and corporate governance functions of their U.S. BHC or U.S. DI subsidiaries, without causing them to fail the use test under Home Country Advanced Approaches. Indeed, they would be required to use the resulting ratings and default and loss estimates based on the definitions contained in the relevant Home Country Advanced Approaches. As a result, it would be impossible for their U.S. BHC and DI subsidiaries to validate the data, key credit and operational risk parameters and outputs of any model based on the U.S. definitions.

Even if the U.S. BHC and DI Subsidiaries of these FBOs were permitted to use the European definitions under the U.S. Advanced Approaches, they could not do so immediately and they would have difficulty validating the data, key credit and operational risk parameters and outputs. This is because most internally active banks have collected their data, and manage their day-to-day risk management operations, along global business lines rather than by country or by entity.[77] Such an approach is consistent with the objectives of enterprise-wide risk management encouraged by bank supervisors.[78] Moreover, because the asset base of their U.S. DI Subsidiaries is so much smaller than that of any other institution that would be subject to the U.S. Advanced Approaches, the resulting data is extremely unlikely to have sufficient statistical significance to be meaningful or useful. Thus, the ratings and default and loss estimates generated at the level of their U.S. BHC and DI subsidiaries, whether on the basis of the U.S. or European definitions, would be used

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[76] The data for Taunus and the U.S. DI Subsidiaries is not currently available because Deutsche Bank manages itself along global, cross-border business lines, instead of on a country-by-country or an entity-by-entity basis.

[77] *See, e.g.*, Basel Committee on Banking Supervision, *Enhancing Corporate Governance for Banking Organisations*, ¶ 35 (Feb. 2006).

[78] *See, e.g., A Supervisory Perspective on Enterprise Risk Management*, Remarks by Governor Susan Schmidt Bies (Oct. 17, 2006), avail. at www.federalreserve.gov/boarddocs/speeches/2006/20061017.

exclusively for U.S. regulatory reporting requirements, in violation of the use tests of Basel II, the European CRD and the Basel II NPR.

Some agency staff have suggested that the primary difference in the definition of default is that some loans that would have to be treated as in default under European CRD would not have to be treated as in default under the proposed U.S. Basel II Capital Framework; and, therefore, that the impact of the difference could be minimized if FBOs were to simply forego their right to treat certain loans in U.S. subsidiaries as not being in default. First, it is not clear that this difference in definition is as simple as this approach suggests. Second, the suggestion that FBOs would, as a practical matter, have to treat their subsidiaries' loans as in default when a similarly situated domestic institution would not have to treat as being in default violates principles of national treatment. Third, the approach would not be of any use in generating data for prior years; while a FBO could, with some burden, generate a list of loans that would be treated as having been in default, the fact that the loans were not treated as being in default on a contemporaneous basis would prevent the calculation and validation of parameters such as ELGD, LGD and EAD.

e. Misleading Public Disclosure

Any public disclosure of the capital ratios of any FBO-Controlled BHCs and their U.S. DI subsidiaries in accordance with the U.S. Advanced Approaches will give a misleading picture of their capital adequacy and could have an adverse impact on its reputation. The figures will change for no reason that is intrinsic to the business of these U.S. affiliates, but instead will reflect intra-group dynamics. In addition, the relatively small size of these U.S. BHC and DI subsidiaries will make it difficult to collect statistically significant data, which will affect the quality of the disclosure. It would be impossible to reconcile the public disclosure made about the U.S. DI subsidiaries pursuant to the U.S. Advanced Approaches with information published in call reports, SEC disclosure documents or any other public information released by a FBO-Controlled BHC or its U.S. DI subsidiaries.

f. Statistically Insignificant Data

In order to be useful, the advanced measurement approach for operational risk requires an institution to have statistically significant data on operational risk. The U.S. BHC and DI subsidiaries of most FBOs, including Deutsche Bank and Barclays, are simply too small to generate statistically significant operational risk data in each of these categories on a stand-alone basis. None of them has experienced enough loss events from operational risk to create an adequate database on which to measure and manage operational risk. As a result, it is simply impossible now and will remain impossible for the foreseeable future for the U.S. BHC and DI subsidiaries of most FBOs to comply with the U.S. Advanced Approach for Operational Risk.

g. Undue Burdens

The burden of requiring the U.S. BHC and DI subsidiaries of FBOs to collect the required data and develop the necessary systems to calculate and report their capital ratios under the U.S. Advanced Approaches substantially outweighs any conceivable benefit. Complying with the new proposed reporting requirement in the Basel II NPR is not simply a matter of using the same data and systems that have been collected and developed to comply with Home Country Advanced Approaches. The reason is that the Basel II NPR would adopt definitions of the term "default" and those key credit and operational risk parameters that depart significantly from the definitions of that term and those parameters in the Basel II Capital Accord and the European CRD. In addition, most internationally active banks have collected their data and developed their systems along global, cross-border business lines, rather than on a country-by-country or entity-by-entity basis.

These differences mean that it would require an immense new and duplicative commitment of resources for most FBOs to start a parallel track of collecting the necessary data and developing the systems necessary for their U.S. BHC and DI subsidiaries to be able to calculate and report their capital ratios under the U.S. Advanced Approaches. They would need to collect seven years of default, loss severity and exposure amount data based on the U.S. definitions of the terms "default", PD, ELGD, LGD and EAD.[79] They would have to develop systems to collect this data by relevant U.S. entity, instead of by global business line.

It is difficult to see what benefits are realized from forcing FBO-Controlled BHC and DI subsidiaries to bear the substantial burden of collecting data and calculating and reporting their respective capital ratios under the U.S. Advanced Approaches instead of using data collected under Home Country Advanced Approaches. In particular, there is no competitive equality reason for requiring the U.S. DI and BHC subsidiaries of FBOs to bear the double burden of gathering two sets of default and loss estimate data, building and validating two models for assigning internal ratings or complying with conflicting use tests under both the Basel II NPR and the foreign parent's Home Country Advanced Approaches. If anything, imposing this double burden and the conflicting use tests would create a substantial competitive inequality. There is also no reason to believe that requiring FBO-Controlled BHCs to calculate their capital ratios under the U.S. Advanced Approaches will result in stronger capital positions. On the contrary, the U.S. Advanced Approaches are expected to result in lower risk-weighted assets and higher capital ratios than the standardized approach. That is one of the reasons why the Basel II NPR includes floors for risk-weighted assets under the U.S. Advanced Approaches.

h. Summary

In short, the unfairness of requiring any of the FBO-Controlled BHCs that would initially be treated as core banks and have not voluntarily elected to be treated as opt-in banks to calculate and report their capital ratios under the U.S. Advanced Approaches makes a

[79] Id. at 55923 (Section 22(c)(4) of the Common Appendix).

compelling case for expanding the authority of the Federal banking supervisors to grant exemptions whenever they would be appropriate in the public interest and consistent with the purposes of the proposed rule.

B. Expanded Definition of Core Bank

A BHC that falls within the proposed expanded definition of core bank, and its DI subsidiaries, should not automatically be required to calculate their capital ratios under the U.S. Advanced Approaches unless a majority of the BHC's consolidated assets are attributable to DI subsidiaries or the DI subsidiaries qualify as core banks on a combined basis. Instead, they should be required to calculate their capital ratios under the U.S. Advanced Approaches only if the Board determines that they intentionally structured their assets or activities to evade the requirement to calculate their capital ratios under the U.S. Advanced Approaches.

This distinction is consistent with the stated purpose of the expanded definition, which is to "recognize[] that BHCs can hold similar assets within and outside DIs" and to "reduce[] potential incentives to structure BHC assets and activities to arbitrage capital regulations."[80] If modified as suggested above, the rule would continue to prevent a BHC with, say, $249 billion in assets attributable to DI subsidiaries, and its DI subsidiaries, from escaping treatment as core banks by establishing a broker-dealer subsidiary and channeling all additional assets to that broker-dealer subsidiary. It would also preserve the Board's discretion to require any BHC and its DI subsidiaries to calculate their capital ratios under the U.S. Advanced Approaches if the BHC falls within the definition of core bank and the Board finds that the BHC and its DI subsidiaries intentionally structured their assets or activities to evade the requirement to calculate their capital ratios under the U.S. Advanced Approach.

But the rule as so modified would recognize that there is no justification for presuming that BHCs with less than a majority of their assets attributable to DI subsidiaries have structured their assets or activities to evade the requirement to calculate capital ratios under the U.S. Advanced or otherwise to arbitrage capital regulations. Such BHCs and their DI subsidiaries have no realistic opportunity or incentive to structure their assets or activities to avoid being subject to Basel II or otherwise to arbitrage capital regulations. Their allocation of assets between DI and non-DI subsidiaries almost always reflects circumstances or business objectives that have nothing to do with avoiding treatment as core banks or minimizing their regulatory capital requirements. In addition, they are the category of BHCs least likely to have anticipated being treated as core banks prior to the public release of the draft Basel II NPR in March 2006. Moreover, unless the definition is limited in this manner, the Basel II NPR will impose substantial burdens on BHCs controlled by FBOs without any reasonable prospect of imposing similar burdens on domestically controlled BHCs or similarly situated domestically controlled S&LHCs or consolidated supervised entities

[80] 71 Fed. Reg. at 55841.

("**CSEs**").[81] This would violate the principle of national treatment and the principle that similarly situated institutions should be treated similarly.

To illustrate the lack of any realistic opportunity or incentive for such a BHC and its DI subsidiaries to evade the requirement to calculate their capital ratios under the U.S. Advanced Approaches, consider the following example which reflects a realistic fact pattern discussed in more detail in the Supplemental Memorandum attached hereto. A BHC with $300 billion in assets at December 31, 2005, has only 10% of its assets attributable to U.S. DI subsidiaries and 90% attributable to U.S. broker-dealer subsidiaries. Neither the BHC nor its DI subsidiaries could possibly have anticipated being treated as core banks before the expansion of the definition in the public release of the draft Basel II NPR in March 2006. It would therefore be far-fetched to argue that its allocation of assets reflected any effort to structure its assets or activities to avoid being subject to Basel II. It would also be far-fetched in the extreme to argue that its allocation of assets reflected any effort to minimize its regulatory capital requirements. Regulatory capital arbitrage between DI and broker-dealer affiliates is virtually always a one-way street *from the broker-dealer to the DI*, and not the other way around. The reason is that the Securities and Exchange Commission's traditional net capital rule is so punishing on illiquid assets such as loans and derivative contracts, which make up such a large portion of a BHC's balance sheet. Thus, at December 31, 2005, the median percentage of assets attributable to the DI subsidiaries of the five largest domestically controlled BHCs was 91%. Less than 10% of their median assets were attributable to their securities or other non-DI affiliates, even if those affiliates originated a much larger percentage of their assets or generated a larger percentage of their revenues.[82]

For example, it is beyond dispute that Taunus, Deutsche Bank's top-tier U.S. BHC, did not structure its assets or activities to avoid being treated as a core bank under the Basel II NPR or to reduce, "arbitrage" or otherwise "game" U.S. capital regulations. As shown in the table below, the percentage mix of assets between DB Securities and its U.S. DI affiliates has been relatively stable since 1999, the year the Basel Committee published its first consultative paper on the proposed new capital accord, two years before the Basel Committee published its first proposed new capital accord in 2001, four years before the U.S. published the ANPR in 2003 (which officially announced the U.S.'s intention to make a distinction between core banks and other banks, and proposed a definition for core bank), and seven years before either the Board publicly released the Draft Basel II NPR or the U.S. published the Basel II NPR in 2006.

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[81] That is, an S&LHC or other non-BHC holding company that controls an SEC-registered broker-dealer that has voluntarily elected to be subject to the consolidated supervision of the SEC.

[82] *See, e.g.*, J.P. Morgan Chase & Co., which reported $598 billion (50%) of assets and $14.6 billion (25%) of revenue attributable to its "Investment Bank" business segment in its annual report on Form 10-K at and for the year ended December 31, 2005 even though 91% of its assets were attributable to its U.S. DI subsidiaries (and less than 9% to its broker-dealer subsidiaries) at December 31, 2005.

At Dec. 31,	Taunus	Attributable to DB Securities	% of Total	Attributable to U.S. DI Subs	% of Total
		(in billions except percentages)			
1999	$179	$90	50%	$52	29%
2000	$198	$98	49%	$46	23%
2001	$227	$140	62%	$44	19%
2002	$224	$149	67%	$42	19%
2003	$291	$208	71%	$35	12%
2004	$337	$253	75%	$34	10%
2005	$365	$264	72%	$34	9%

Sources: Annual Reports of Taunus on Form FR Y-9C, Focus Reports of DB Securities and Call Reports for U.S. DI subsidiaries at December 31 of each year.

Before 2006, Taunus had insufficient information and no incentive to structure its assets or activities between DB Securities and its U.S. DI subsidiaries to avoid being required to calculate and report its capital ratios under the U.S. Advanced Approaches. Nor does the data suggest any such structuring. Indeed, the percentage of assets attributable to Taunus's U.S. DI subsidiaries has only changed by approximately 3% of Taunus's total assets since publication of the ANPR.

Nor does the data suggest that Taunus changed the percentage mix of assets attributable to DB Securities and its U.S. DI subsidiaries to "arbitrage" or otherwise "game" its overall U.S. capital requirements. On the contrary, as shown in the table below, both DB Securities and DBTCA, Deutsche Bank's flagship U.S. DI subsidiary, have maintained regulatory capital levels well above U.S. regulatory minimums and DBTCA has been growing its capital ratios since 2003 and before.

	DBTCA			DB Securities
At Dec. 31,	Tier 1	Total	Leverage	Net capital as % of aggregate debit balances(1)
1999	18%	19%	14%	83%
2000	26%	27%	18%	121%
2001	29%	29%	16%	33%
2002	33%	36%	17%	29%
2003	38%	40%	23%	50%
2004	40%	43%	25%	27%
2005	39%	40%	24%	50%

(1) Regulatory minimum is 2% of aggregate debit balances.

Sources: Call Reports of DBTCA and Focus Reports of DB Securities.

Requiring BHCs that could not possibly have anticipated being treated as core banks before March 2006 to start reporting their capital ratios under the U.S. Advanced Approaches

within two years after the proposed rule's effective date would also violate the principle of due process. They would not have been given adequate notice that they would be treated as core banks that would need to gather five to seven years of internal data within two years after the proposed rule's effective date.

Finally, the only BHCs that currently have less than a majority of their assets attributable to DI subsidiaries, or more than a majority of their assets attributable to broker-dealer subsidiaries, are controlled by FBOs (*e.g.*, those controlled by Barclays and Deutsche Bank). There is also no reasonable prospect that any domestically controlled BHC would have less than a majority of its assets attributable to DI subsidiaries. The only category of domestically controlled financial institutions that has a similar percentage of assets attributable to DI and broker-dealer subsidiaries are S&LHCs and CSEs. But, as noted above, they have carefully structured their operations to avoid being treated as BHCs by limiting their DI subsidiaries to "grandfathered" savings associations, Utah industrial banks or other DIs that are not treated as "banks" for purposes of the BHC Act.[83] These structuring options are not open to FBOs that have a U.S. branch, agency or commercial lending company subsidiary in the United States, because they are subject to the BHC Act whether or not their U.S. DI subsidiaries are limited to savings associations, Utah industrial banks or other DIs that are not treated as banks for purposes of the BHC Act.

As a result of these circumstances, the proposed rule will violate the principle of national treatment at the present time unless FBO-controlled BHCs with less than a majority of their assets attributable to DIs are excused from calculating their capital ratios under the U.S. Advanced Approaches in the absence of a determination by the Board that they intentionally structured their assets or activities to evade the requirement to comply with the U.S. Advanced Approaches. The Federal banking agencies have long recognized that the principle of national treatment requires more than facially neutral laws and practices.[84] It requires equality of competitive opportunities (including equality of competitive burdens), which was described in the 1998 National Treatment Study as "a higher standard than *de jure* national treatment, based simply on identical treatment in law and regulation."[85] If facially neutral laws or "practices have a greater impact on foreign institutions than domestic, this is a

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[83] As described in note 57 above, for example, when Merrill Lynch recently agreed to acquire First Republic Bank, an FDIC-insured nonmember bank which otherwise would have caused it to become a bank holding company, it announced that it was structuring the transaction so that First Republic Bank would be merged with and into Merrill Lynch Bank and Trust Co., FSB, a federal savings association. Thus, Merrill Lynch will remain an S&LHC, but will not become a BHC. Unlike BHCs, S&LHCs with more than $250 billion in consolidated total assets are not core banks for purposes of the Basel II NPR, and the OTS does not impose minimum capital or capital reporting requirements on S&LHCs.

[84] *See, e.g.*, 12 C.F.R. § 225.90(b).

[85] Department of the Treasury, *National Treatment Study*, at 28 (1998).

denial of national treatment."[86] The proposed rule would have a substantially greater adverse impact on FBO-controlled BHCs at this time because at December 31, 2005:

- the top percentage of assets attributable to U.S. DI subsidiaries (less than 10%) of all FBO-controlled BHCs that would be treated as core banks under the Basel II NPR was substantially below the median percentage of assets attributable to DI subsidiaries (91%) of all domestically owned BHCs that would be treated as core banks under the Basel II NPR; and

- the top amounts and percentages of assets attributable to U.S. DI subsidiaries ($34 billion and less than 10%) of all FBO-controlled BHCs that would be treated as core banks under the Basel II NPR were substantially below the range of absolute amounts and percentages of assets attributable to DI subsidiaries ($53 billion to $209 billion, and 76% to 100%) of the top ten domestically controlled BHCs that would *not* be treated as core banks under the Basel II NPR.

The proposed rule would also violate the principle that similarly situated institutions should be treated similarly because at December 31, 2005 the top amount of assets attributable to U.S. DI subsidiaries ($34 billion) of all FBO-controlled BHCs that would be treated as core banks under the Basel II NPR was approximately equal to or substantially below the range of assets attributable to DI subsidiaries ($25 billion to $325 billion) of several S&LHCs and CSEs that have DI subsidiaries but would *not* be treated as core banks under the proposed rule or otherwise required to comply with Basel II on a compulsory basis.

C. Option to Use the Standardized Approach for Credit Risk

You requested comment on whether U.S. DIs and BHCs should be permitted to use a U.S. version of the "standardized approach" of the Basel II Capital Accord and on the appropriate length of time for such an option.[87] The U.S. DI and BHC subsidiaries of an FBO should have the option to comply with U.S. minimum capital requirements based on the Basel II Standardized Approach for Credit Risk.

There is no competitive equality reason for requiring the U.S. DI and BHC subsidiaries of FBOs that are subject to Home Country Advanced Approaches to bear the double burden of gathering two sets of default and loss estimate data, building and validating two models for assigning internal ratings or complying with conflicting use tests under both the Basel II NPR and the FBO's Home Country Advanced Approaches. If anything, imposing this double burden and the conflicting use tests would create a substantial competitive inequality.

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[86] Statement of John P. LaWare, 1992 Fed. Res. Interp. Ltr. LEXIS 11, at 2 (Jan. 27, 1992).

[87] Id. at 55841 (Question 7).

There is also no reason to believe that the Basel II Standardized Approach for Credit Risk would systematically result in lower risk-weighted assets or higher capital ratios than the U.S. Advanced Approach for Credit Risk. On the contrary, the U.S. Advanced Approach for Credit Risk is expected to result in lower risk-weighted assets and higher capital ratios than Basel I or the Basel II Standardized Approach for Credit Risk. That is one of the reasons why the Basel II NPR includes floors for risk-weighted assets under the U.S. Advanced Approaches.

Virtually every host country that has adopted Basel II will give the host-country DI and BHC subsidiaries of U.S. and other foreign financial institutions the option to use the Basel II Standardized Approach for Credit Risk to calculate their risk-weighted assets to reflect credit risk. By allowing the U.S. BHC and DI subsidiaries of FBOs to rely on the Basel II Standardized Approach for Credit Risk, the Federal banking supervisors will avoid giving other host countries an excuse to impose double burdens or conflicting conditions on the host-country DI or holding company subsidiaries of U.S.-domiciled BHCs, S&LHCs or CSEs. It would also put FBOs on a level playing field with their U.S. domiciled competitors, which have the option of using the Basel II Standardized Approach for Credit Risk in the major non-U.S. financial centers in which they conduct operations.

D. Option to Use Basic Indicator Approach or Standardized Approach for Operational Risk.

The U.S. DI and BHC subsidiaries of an FBO should also have the option to comply with U.S. minimum capital requirements based on the Basel II Basic Indicator Approach for Operational Risk or the Basel II Standardized Approach for Operational Risk.

A BHC or DI subsidiary that falls within the proposed definition of core bank should not automatically be required to calculate its operational risk in accordance with the U.S. Advanced Approach for Operational Risk. Instead, a BHC or DI subsidiary should have the option to use the Basel II Basic Indicator Approach for Operational Risk or the Basel II Standardized Approach for Operational Risk. Similar to the Basel II Standardized Approach for Credit Risk, the simple approaches to operational risk measurement are expected to result in higher notional risk-weighted assets and lower capital ratios than the U.S. Advanced Approach for Operational Risk. Furthermore, core banks with less than a *multiple* of $250 billion in consolidated total assets will almost never be able to produce sufficient internal operational risk data to satisfy the U.S. Advanced Approach for Operational Risk using internal operational risk models that are feasible at this time.

For example, Deutsche Bank has developed an internal model to estimate operational risk on a worldwide basis that contains 23 of the 56 possible regulatory operational loss types (corresponding to business line /event type cells). Even for these 23 loss types sufficient internal data could only be gathered for 4 loss types; the remaining 19 needed external industry consortium and commercial data to be able to build an advanced model at all - despite the fact that Deutsche Bank is one of the world's largest and most diverse international banking organizations, with approximately €992 billion in assets at December

31, 2005. In contrast, Deutsche Bank has estimated that Taunus Corporation, its top-tier U.S. BHC with approximately $365 billion in consolidated assets, would be able to gather sufficient internal operational risk data for only 1 of these 23 group-wide loss types and would be dependent on external data for the remaining 22. In short, Taunus simply does not have the size or scope of operations to use Deutsche Bank's internal operational risk model on a local basis. Although the Basel II NPR permits core banks to fill any gaps in their internal operational risk data with external data, we believe that using external data for 22 of the 23 parameters would make the model useless as a risk management tool and convert it into a meaningless exercise in mathematical calculation.

There is also no competitive equality reason for requiring the U.S. DI and BHC subsidiaries of FBOs that are subject to Home Country Advanced Approaches to bear the double burden of gathering two sets of operational risk data, building and validating two internal operational risk models or complying with conflicting use tests under both the Basel II NPR and the FBO's Home Country Advanced Approaches. If anything, imposing this double burden and the conflicting use tests would create a substantial competitive inequality.

Virtually every host country that has adopted Basel II will give the host-country DI and BHC subsidiaries of U.S. and other foreign financial institutions the option to use the Basel II Basic Indicator Approach for Operational Risk or the Basel II Standardized Approach for Operational Risk to calculate their operational risk exposures. By allowing the U.S. BHC and DI subsidiaries of FBOs to rely on the Basel II Basic Indicator Approach for Operational Risk or the Basel II Standardized Approach for Operational Risk, the Federal banking supervisors will avoid giving other host countries an excuse to impose double burdens or conflicting conditions on the host country DI or holding company subsidiaries of U.S.-domiciled BHCs, S&LHCs or CSEs. It would also put FBOs on a level playing field with their U.S. domiciled competitors, which have the option of using the Basel II Basic Indicator Approach for Operational Risk or the Basel II Standardized Approach for Operational Risk in the major non-U.S. financial centers in which they conduct operations.

E. Option to Use Home-Country Advanced Approaches

The U.S. DI and BHC subsidiaries of an FBO should have the option to use the U.S. capital rules to calculate their capital elements while using the FBO's Home Country Advanced Approaches to calculate their credit and operational risk exposures[88], subject to the floors contained in the Basel II NPR.

As noted above, there is no competitive equality reason for requiring the U.S. DI and BHC subsidiaries of FBOs to bear the double burden of gathering two sets of credit and

[88] For operational risk, this means that an appropriate segment is carved out from the FBO's group-wide capital requirement and assigned to the U.S. BHC and DI subsidiaries, based upon a robust allocation mechanism which is subject to independent validation. The US capital rules are then applied to this carved out operational risk capital requirement.

operational risk data[89], building and validating two models for estimating credit or operational risk or complying with conflicting use tests under both the Basel II NPR and the FBO's Home Country Advanced Approaches. If anything, imposing this double burden and the conflicting use tests would create a substantial competitive inequality.

There is also no reason to be concerned that the use of Home Country Advanced Approaches will result in credit or operational risk exposures that are systematically lower than what would be produced using the U.S. Advanced Approaches, especially if the calculations are subject to the floors contained in the Basel II NPR. In addition, by allowing the U.S. BHC and DI subsidiaries of FBOs to use the FBO's Home Country Advanced Approaches to calculate their credit and operational risk exposures, the agencies will avoid giving other countries an excuse to impose double burdens or conflicting conditions on the foreign DI or holding company subsidiaries of U.S.-domiciled BHCs, S&LHCs or CSEs.

F. Top-Tier BHC

The text of the proposed rule should clearly state that the only U.S. BHC subsidiary of an FBO that would be considered a core bank is the FBO's top-tier U.S. BHC subsidiary, and not any of its intermediate U.S. BHC subsidiaries. This concept is clearly stated in the release accompanying the text of the rule,[90] but it should be included in the text of the rule itself to avoid any uncertainty.

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[89] It is also worth noting that many cross-border group-wide risks and exposures cannot be measured adequately on a country-by-country basis.

[90] Id. at 55841.

G. Retain SR 01-01

Finally, we believe that the Board should retain SR 01-01. That SR letter exempts a top-tier BHC controlled by an FBO from complying with the Board's minimum capital requirements otherwise applicable to U.S. BHCs, as long as its FBO parent is well-capitalized and well-managed under standards that are comparable to those of U.S. banks controlled by financial holding companies.

Note that SR 01-01 was implemented in order to promote the principles of national treatment by giving FBOs the benefits of consolidation for U.S. tax purposes to the same extent as their U.S. domestic competitors. It gives FBOs the same ability that U.S. banking organizations have to net gains and losses in different U.S.-based subsidiaries for purposes of calculating Federal income tax liabilities. SR 01-01 was adopted to ensure consistency with principles of national treatment, effectively giving FBOs the same ability that U.S. banking organizations have to net gains and losses in different U.S.-based subsidiaries for purposes of calculating U.S. federal tax liabilities. The Board does not exempt the top-tier BHC from its capital reporting requirements, so the policy does not compromise the Board's ability to supervise an FBO's U.S. operations.

We believe that the reasons for issuing SR 01-01 remain sound, and that home country capital standards based on Basel II are likely to be just as comparable to U.S. capital standards based on Basel II as capital standards based on Basel I were.