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May 29, 2007 *Via email*

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Regulation Comments
Chief of Supervision
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Attention: No. 2006-33

Re: Proposed Supervisory Guidance for Internal Ratings-Based Systems for Credit Risk, Advanced Measurement Approaches for Operational Risk, and the Supervisory Review Process; 72 Federal Register 9084, February 28, 2007

FDIC: Basel II Supervisory Guidance
FRB: Docket No. OP–1277
OCC: Docket No. OCC–2007–0004
OTS: Docket No. 2007–06

Ladies and Gentlemen:

The American Bankers Association ("ABA") appreciates this opportunity to comment on the Supervisory Guidance proposed by the Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision ("Agencies") to clarify their supervisory processes for the Basel II Advanced Internal Ratings-Based Approach and Advanced Measurement Approach ("AIRB" and "AMA" respectively, collectively the "Advanced Approaches"). On behalf of the more than two million men and women who work for the nation's banks, ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, savings banks, and bankers banks – makes ABA the largest banking trade association in the country.

Before commenting on the Supervisory Guidance, we wish to reiterate some positions relative to the application of Basel II that we have made in the past:

- **The rules for the Advanced Approaches in the U.S. should be harmonized with the international Basel II accord, considering the suggestions from bankers and ABA.**[1]

  ABA remains committed to the adoption of the Advanced Approaches. The Agencies have proposed a number of changes to the Basel Committee's Basel II Framework ("Framework") that would reduce the sensitivity of risk measurement and impose sizable compliance costs on adopting institutions, and therefore competitively disadvantage U.S. banks. Accordingly, we recommend that the Agencies adopt rules that more closely adhere to the Framework.[2] Prudent changes to the proposal could make the Advanced Approaches a workable, effective means for relating capital to risk in adopting institutions.

- **The Agencies should promptly finalize the rules for the Advanced Approaches.**

  Development of rules that implement the Framework in the U.S. has been a long process and has become very expensive for banking firms that adopt the new system. The Agencies have more than once postponed the parallel runs and implementation of Basel II in the U.S. At this point, some adopters are waiting before committing more time and money to implementation. Meanwhile, the other nations that will use Basel II have already finalized their rules, at least for Pillar I. Therefore, multinational banking institutions are facing the prospect of having to deal with a regulatory capital system in the U.S. that diverges from other nations implementing the Framework. It is time for the Agencies to finalize the rules and begin implementation of Basel II. Further significant delay will escalate costs and compound frustrations.

- **The Standardized Approaches from the Framework should be developed expeditiously and offered as an option for all banks.**

  The Standardized Approaches are of particular importance to large regional banking firms, since the Advanced Approaches are far too expensive and complex for their needs, and the existing "Basel I" and proposed "Basel IA" standards do not contain adequately risk-sensitive regulatory capital. The Basel IA proposal also fails to recognize the ways that banks, particularly larger institutions, manage and mitigate risk.[3]

  The Agencies participated in development of the Basel II accord and approved it in 2004, including the terms and conditions of the Standardized Approaches. Thus, including this alternative in a menu of capital options for U.S. banks should be acceptable to them and should not require much additional work. Bankers have been requesting the Standardized Approaches since last August, and the regulators acknowledged their need in the Basel II proposal last

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[1] See ABA's letter on the Basel II proposal, *www.fdic.gov/regulations/laws/federal/2006/06c41ac96.pdf*, March 26, 2007.
[2] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, June 2004.
[3] See ABA's letter on the Basel IA proposal, *www.fdic.gov/regulations/laws/federal/2006/06c34ac73.pdf*, March 23, 2007.

September.[4] The time for developing the Standardized Approaches as a capital standards option is long overdue, and the Agencies should expedite its adoption.

Adopting the Standardized Approaches will allow larger banks to phase into the Basel II standards and move toward state-of-the-art Advanced Approaches. This may be particularly important if the capital markets show a bias against banks that do not adopt Basel II (making them pay more for capital and funding). It can also be helpful for large regional banks that operate across borders and have to deal with divergent Basel II standards abroad. The Standardized Approaches should also be available to institutions that are considered as "core banks," allowing these institutions to participate in internationally agreed to Basel II standards.

- **The Agencies should allow phased implementation for the Advanced Approaches.**

ABA notes that, in our discussions of implementation with foreign bank trade associations, other nations agreeing to the Framework allow a phased-in implementation of the Advanced Approaches.[5] ABA recommends that banks be permitted to qualify for and adopt the Advanced Approaches for some portfolios or business lines, as permitted by other countries, while continuing to use less sophisticated approaches for other portfolios. This makes even more sense when combined with the option of using the Standardized Approaches.

The procedure proposed in paragraph 20 of the "Proposed Supervisory Guidance on the Supervisory Review Process" can serve as a model for allowing institutions to phase into the Basel II Advanced Approaches. The paragraph specifies that, "Banks adopting the U.S. Advanced Framework must comply with the qualification requirements not just for initial qualification, but also for ongoing use. A bank that falls out of compliance with the qualification requirements would be required to establish a plan satisfactory to its primary Federal supervisor to return to compliance, as discussed in the U.S. Advanced Framework." Just as this process would be applied to an institution whose Advanced Approaches system has fallen out of compliance, it could also be used to allow an institution to phase into these approaches in the first place. This would avoid a situation in which an institution is barred from using the Advanced Approaches for capital purposes until ***all*** of its systems are fully approved. Such flexibility would make it easier for institutions to move toward the most advanced regulatory capital standards.

I. General Recommendations for the Supervisory Guidance

The following comments reflect feedback ABA has received from the ABA Capital Working Group (which focuses on operational risk management), ABA Enterprise Risk Management Group, ABA Model Validation Working Group, individual banking organizations that would be required to adopt the Framework's Advanced Approaches (so-called "core" institutions) and banking organizations that are considering doing so (so-called "opt-in" organizations). We focus here on the central

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[4] Agencies, "Risk-Based Capital Standards: Advanced Capital Adequacy Framework," 71 *Federal Register* 55830, September 25, 2006.
[5] ABA is a founding member of the International Banking Federation, whose membership includes the national banking associations of all of the nations that are core members of the Basel Committee on Banking Supervision.

themes, leaving reactions to specific points and technical aspects of the proposal for comment by individual banking firms.

The Supervisory Guidance proposes three sets of standards for supervisors when examining banking institutions that adopt the Advanced Approaches. These supervisory standards go along with the Basel II rules, as proposed. Two of the three proposed sets of standards cover what examiners should look for to determine whether a bank or bank holding company has suitable (1) AIRB systems and procedures for credit risk ("IRB Guidance"), and (2) AMA systems and procedures for operational risk ("AMA Guidance"). For institutions qualified to use these Advanced Approaches, the third set of standards covers the supervisory review process ("ICAAP Guidance").[6] In Basel II parlance, after an institution uses its Advanced Approaches to calculate its minimum risk-based capital requirement under "Pillar I," supervisors would use the standards in the IRB and AMA Guidances to check whether the calculations are done correctly. Then they would use the standards in the ICAAP Guidance to determine when additional capital is warranted under "Pillar II."

ABA appreciates the improvements in the proposed Supervisory Guidance from the earlier proposals.[7] The proposal is more user-friendly than the August 2003 and October 2004 versions and is better organized, and the examples provided in the AMA and IRB Guidances are helpful.[8]

The three Supervisory Guidances are discussed separately in sections II, III and IV of this letter. However, bankers expressed the following overarching themes with respect to all three:

- **The provisions in the Guidances should be viewed as *guidance* for supervisors, not mandates**.

  Most of the 140 proposed supervisory standards are expressly prescriptive with regard to what a bank "should" or "must" do. Moreover, many of the restrictions on parameters proposed in the Guidances and in the Basel II proposal are inconsistent with institutions' internal measurements, and thus with these institutions' best judgments for internal risk management.

  The Guidances are overly prescriptive in demanding that banks set policies to justify every aspect of their models, rather than setting standards for how supervisors will judge those models. Excessive supervisory constraint deviates from a primary intent of Basel II: to foster the best possible risk measurement and management in banks. The excessive details called for – as mandates, not as examples – would require detailed analysis and documentation for many intermediate steps in the implementation process. This would pose a substantial and unnecessary bureaucratic burden on banks. It would also inhibit advances in risk modeling and management by making trials much more time consuming and expensive. And it could lead to micro-management by supervisors.

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[6] ICAAP is an acronym for "internal capital adequacy assessment process."
[7] Agencies, "Internal Ratings-Based Systems for Corporate Credit and Operational Risk Advanced Measurement Approaches for Regulatory Capital," 68 *Federal Register* 149, August 4, 2003, and Agencies, "Internal Ratings-Based Systems for Retail Credit Risk for Regulatory Capital," 69 *Federal Register* 207, October 27, 2004.
[8] For example, common treatment of retail and wholesale credit exposures is considered together in the IRB Guidance.

Supervisors should view the provisions of the Guidances as just that – guidance – rather than prescribed forms for the models. Institutions' risk metrics should be judged on their own merits, not relative to preconceived procedures. Supervisors' focus should be on institutions' validation of their models. The proposal establishes rigorous standards for model validation.

- **Supervisors should not expect an institution's internal risk management processes to be identical to the IRB, AMA and ICAAP processes.**

  At several points, the Guidances prescribe that the procedures an institution uses in its AIRB, AMA and ICAAP processes should be "consistent with" or "representative of" its own internal risk management processes.[9] Supervisors should not interpret these points to mean that internal and Basel II processes should be identical. Supervisors do not want to prevent institutions from trying out new procedures in their internal risk systems before gaining supervisory acceptance in their Basel II systems; this would deter progress toward superior risk measurement and management.

- **Several proposed supervisory standards prescribe board of director responsibility for risk management policies for what is more appropriately the role of management practices**.

  The supervisory standards need to distinguish between policies and procedures so as not to blur the lines of responsibility between the board and management. This issue arises in S 1-3, S 7-3 and S 7-6 in the IRB Guidance, S 4, S 5 and S 10 in the AMA Guidance, and paragraphs 16, 37 and 41 in the ICAAP Guidance. It is inconsistent with the practices of most institutions, and inconsistent with board time management, to have the board go so deeply "into the weeds." Instead, the lines of responsibility of the board and management should be established by the board, not by regulation.

- **The Agencies should make every effort to assure consistency in application of the supervisory standards.**

  Bankers have expressed concerns that the standards will be imposed differently from one institution to another – even by examiners within a single Agency. This would mean that some institutions have a harder time qualifying their AMA or AIRB systems, or would face higher add-on capital requirements. So that all adopters of the Advanced Approaches are on equal footing, the supervisory staffs of the Agencies should coordinate in back-testing and fully validating their supervisory standards. This coordination would have the added benefit of cross-pollination of best practices in Basel II supervision. According to some bankers, a method that has been used with some success in other nations involves a supervisor approval committee for each institution, as well as standards for supervisors, not just for banks.

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[9] For example, note proposed supervisory standards S 1-4 in the IRB Guidance and S 9 in the AMA Guidance, as well as paragraph 40 in the ICAAP Guidance.

II. IRB Guidance

An institution would use its AIRB internal rating and segmentation systems and quantification processes for credit risk in calculating its minimum risk-based capital requirement. However, first the IRB Guidance would direct supervisors to determine that the institution has data that support accurate and reliable credit risk measurements, as well as rigorous management oversight and controls with continuous monitoring and validation. The following points summarize the reactions of the bankers we spoke to with respect to the proposed IRB Guidance.

- **S 1-1** should not require the AIRB system to maintain both average expected loss given default ("LGD") and downturn (stressed) LGD as separate parameters. In practice, there would be little difference between the two parameters. This is because expected LGDs are to be computed at a high confidence level (99.9 percent confidence level for capital), which is already a stressed environment. The stresses used for stressed LGDs would normally dominate the calculations of the expected LGDs. Moreover, stressed situations would be handled by the ICAAP, so dual LGDs throughout are overkill. Any call for dual LGDs is especially superfluous for exposures to loans with liquid collateral that are marked to market and can be liquidated if margin calls are not met.

- **S 1-2** is a prime example of a requirement for unwarranted documentation. The stipulated scope of risk management reports is so prescriptive and excessive that it would likely overwhelm senior management and lose the main message. Management seldom needs all the details, but does need exceptions-based reports that highlight where significant weaknesses were detected. Instead of detailing what must be included in risk management reports, the supervisory standard should provide a principle for management's responsibility to obtain sufficient information to understand the current risk picture.

- **S 1-4** would require an institution to justify its risk parameters for the overall organization as well as at each subsidiary bank. However, some institutions estimate risk parameters only at the highest level, for the very good reason that the pooled dataset leads to superior parameter estimates. Since there is no reason to believe that the parameters would be different at different subsidiaries, institutions should not be required to reparameterize at the individual depository institution level.

- **S 2-1, S 3-1 and S 4-2** would require that risk parameters be estimated using the IRB definition of default from the Basel II proposal. This definition provides that a credit-related loss of five percent or more on the sale of an asset would be treated as a default, and all other credits to the same borrower would be treated as in default. Bankers and ABA have recommended that the U.S. Basel II rule should drop this definition, or else revert to the definition in the Framework.

  If this regulatory definition is retained, then institutions will have to change their existing models – at considerable cost. Multinational institutions will have to go to great and unproductive expense to maintain multiple datasets, rating and quantification models, and parameter estimates. Moreover, this definition is more restrictive than that long used in the industry – which would render many external sources of data useless for risk management in institutions on the Advanced Approaches. This definition would also discourage certain risk mitigation sale strategies. For example, institutions could be inhibited from diversifying out of positions (i) that were originally taken at below-market rates or (ii) when there is a change in market perception of an obligor.

- **S 2-3** should not require both LGD and ELGD, as argued under S 1-1 above.

- **S 2-7** would require a credit risk modeling process to specify "how quickly obligors are expected to migrate from one rating grade to another in response to economic cycles." Lenders cannot reasonably predict *a priori* the rate of change of the credit risk rating of borrowers under all potential circumstances. Bankers indicate that the pace of migration depends on the length, strength and type of economic event, and is unique to every situation.

- **S 3-6** would require institutions to regrade retail exposures at least once every quarter. Bankers believe that the requirement should be for annual, not quarterly, reevaluations. Broad experience suggests that retail exposures do not change quickly enough on a regular basis to warrant review every three months – especially for high quality credits. In cases where there may have been a measurable shift prior to the end of an annual review cycle, supervisors can discuss with management the need for an unscheduled update (if it has not already dealt with the situation).

- **S 4-3** should not require ratings for both obligors and guarantors for wholesale guarantees. This requisite is burdensome and unnecessary for risk measurement. Grading the obligor is of no value when the guarantor guarantees several facilities of multiple obligors (*e.g.*, for a parent with several subsidiaries). Similarly, when the loan contract calls for the guarantor to make good on scheduled loan payments, the default condition attaches to the guarantor, not the obligor. An institution may employ a guaranty when the guarantor holds a higher credit rating than the obligor. However, if the creditworthiness of the obligor turns out to be higher than that of the guarantor, then this process will produce a conservative probability of default estimate. This burden is important for small business and middle-market lending, where guarantees are common practice.

- **S 4-5** should not require that all retail loans with tranched guarantees be analyzed under the securitization treatment. Such tranches will not have direct or inferred ratings and would be subject to the more operationally burdensome Supervisory Formula Approach. Instead, an option to ignore the guarantee should be granted so that such credits can be treated under the basic retail rules.

- **S 4-24** would mandate that "estimates of additional drawdowns prior to default for individual wholesale exposures or retail segments *must not be negative*" (emphasis added). However, some institutions report that their experience and internal models consistently show negative drawdowns prior to defaults for some exposures. Therefore, this supervisory principle contradicts **S 1-4**, which requires that "risk parameters … are representative of [an institution's] credit risk." We therefore request that the non-negativity limitation be stricken in the final supervisory standard.

- **S 7-5** would require that an institution's AIRB practices be consistent with internal risk management systems. It may not be possible for some processes to be consistent with all other rules as well as supervisors' preferences. For example, loan loss allowance systems must comply with accounting and U.S. Securities and Exchange Commission rules, and may therefore have to be inconsistent with internal and AIRB models. Paragraph 16 acknowledges the need for "flexibility" due to "other uses" for the risk models. It is important that supervisors apply the supervisory standard with this flexibility in mind.

- **S 7-14** is an example of where the Supervisory Guidance provides too much authority for examiners to micromanage banks. The proposed standard would require institutions to "establish ranges around the estimated values of risk parameter estimates and model results in which actual outcomes are expected to fall and have a validation policy that requires them to assess the reasons for differences and that outlines the timing and type of remedial actions taken when results fall outside expected ranges." The proposed standards should not specify how an institution models risk and validates its models, but instead should allow the institution to use its own processes – as long as it can defend the reasonableness of its approach.

- **S 8-1** prescribes an expectation of accuracy from stress tests that is both unlikely to be met in practice and targeted at the wrong goal. An example of the expectation appears in paragraph 3: "A bank that is able to accurately estimate risk-based capital levels during a downturn can be more confident of appropriately managing risk-based capital." A stress test identifies a range of impacts and results from an abnormally severe event, such as a strong economic downturn. This data helps management prepare for strategic implications and plan mitigating steps. These preparations are far more important for effective risk management than are precise forecasts of what will happen in strained scenarios that will never occur exactly as modeled. Focus on the forecasts themselves would actually be counterproductive by giving a false sense of accuracy and security.

- **S 9-3**. On the surface, it appears reasonable to require institutions to "use the same method for determining risk-based capital requirements for all similar transactions." However, at issue is how closely supervisors interpret the term "similar." This provision will be counterproductive if examiners focus on differences in approaches based on degrees of similarity in exposures.

- **S 11 series**, the proposed supervisory standards for securitization exposures, seems to be written for institutions that underwrite and sell securitizations or hold residual equity tranches of securitizations. However, the language of the IRB Guidance does not explicitly state that this is the case and could be interpreted by examiners as applying to any balance sheet exposure related to securitizations, including purchases of securitized assets or participations in syndicated loans or lines of credit. For institutions with simple exposures to securitizations, such as purchasing and holding positions in non-equity tranches of securitized assets, or limited participation in syndications of asset-backed commercial paper liquidity facilities, the exposures carry essentially the same risks as loans or committed lines, and therefore should not be subject to the proposed operational complexities. The final Guidance should restrict the range of securitization activities to which the proposed standards apply – *e.g.*, to origination, underwriting and equity holdings. Further, the Guidance should explicitly allow institutions that purchase limited amounts of securitizations to treat such exposures as part of their general wholesale or retail exposures.

III. AMA Guidance

An institution would use its AMA quantification processes for operational risk in calculating its minimum risk-based capital requirement. Before using its AMA structure, the AMA Guidance would direct supervisors to determine that the institution has data that support accurate and reliable operational risk measurements, as well as rigorous management oversight and controls with continuous monitoring and validation. The following points summarize the reactions of the bankers we spoke to with respect to the proposed AMA guidance.

- Several of the proposed supervisory standards in this Guidance would require institutions to "demonstrate" analysis that is beyond the state of the art in operational risk measurement. This applies to S 11, S 16, S 25 and S 28. Such a demonstration would call for proving and providing clear and certain evidence, which is not possible. Supervisors need to understand that operational risk management is still evolving. At this time, well reasoned, thoughtful and well documented consideration – not proof – is the best that can reasonably be achieved.

- **S 4**. The board of directors should not be required to evaluate the effectiveness of and approve the institution's AMA system annually, as proposed. Evaluation and approval of the system is a function of management. Very few board members have the competence to do such an evaluation, and it would be difficult to find qualified individuals to fulfill this function on the board, along with the other board responsibilities. The board should be authorized to designate responsibility for this review to senior management, where sufficient expertise is expected to review the system competently. Moreover, there is no clear reason for review as often as annually, unless there has been a systematic change in the AMA system or environment for its use.

- **S 10**. The explanatory text on the reporting requirement states, "Comprehensive management reporting, geared toward the firm-wide operational risk management function and line of business management, should include … changes in factors signaling an increased risk of future losses and … operational risk causal factors." Bankers feel that this requirement cannot be met at this time. In many operational risk events, the causal factors cannot be uniquely determined retrospectively, let alone identified as signs of an increase in future losses. A direct relationship between a change in risk factors and future losses cannot be shown except for highly predictable routine losses where the amount of available and relevant data supports such a relationship. We recommend that the supervisory standard be amended to "where possible, changes in factors signaling an increased risk of future losses (for example, changes in causal factors)."

- **S 24** should allow supervisors to accept AMA systems where the four critical elements of operational risk management (*i.e.*, internal and external operational loss event data plus assessments of the business environment and internal control factors) are integrated in modeling. The proposed standard suggests that institutions should use the four elements separately, then combine them. Since the most effective way for some institutions to assess operational risk is through a joint approach, not separated then combined, the proposed standard should be adjusted to clarify acceptance of this practice.

- **S 26**, on operational risk offsets, should allow for a range of mitigants. Eligibility for operational risk offsets should be allowed in all circumstances that conform to the established criteria, and not be limited to only the two examples identified.

- **S 28** proposes that supervisors look for a degree of validation of dependence that is unattainable. Instead the proposal should permit institutions to make reasonable assumptions about dependence and should clarify what is expected in justifying these assumptions. As proposed, an institution would have to demonstrate to the satisfaction of its supervisors that its process for estimating dependence among operational losses within and across business lines and operational loss events "is sound, robust to a variety of scenarios, and implemented with integrity. If the bank has not made such a demonstration, it must sum operational risk exposure estimates across units of measures to calculate its total operational risk exposure." However, no data or evidence can indisputably confirm dependence. In practice, modelers must make assumptions. The proposal should accept this approach as best industry practice and provide guidance on what supervisors should look for in justification for the assumptions. The alternative of being forced to sum up all operational risk exposures is unreasonably conservative.

- **S 29** should be amended to remove the artificial 20 percent limit. As proposed, the measured operational risk exposure could be reduced by no more than 20 percent through the use of risk mitigants. This limit does not promote the use and development of risk mitigation, and could, in fact, lead to suboptimal risk-mitigation. While we acknowledge that the exposure cannot be totally eliminated because not all claims get paid and there are often added litigation costs, we believe that any supervisory limit focuses on the wrong dimension. We recommend that the Guidance should instead address the issues of extent and certainty of coverage and solvency. For example, institutions should be allowed to use probability of payment, justified by historical data and including added litigation costs.

IV. ICAAP Guidance

The proposed ICAAP Guidance addresses continuing supervisory review in the Advanced Approaches once an institution has been certified to use them. Supervisors would also use the proposed supervisory standards to determine when an institution would be required to hold capital above the minimum requirements, as calculated with AIRB and AMA models. Examiners currently have this authority. The Guidance proposes areas where current authority would be augmented for the Advanced Approaches.

Bankers appreciate that the proposed Guidance lays out a more principles-based approach for supervision of risk management. The nature of this Guidance means that it can be appropriately tailored to the circumstances of each institution. ABA recommends that the final Guidance should adhere to this approach, and recommends further that it be applied to the more prescriptive IRB and AMA Guidance proposals. Banker recommendations on the proposed Guidance follow.

- **Paragraph 7** says that "supervisors generally expect banks to hold capital above their minimum regulatory capital levels, commensurate with their individual risk profiles, to account for all material risks." Bankers are concerned that supervisors will use this standard to require ever increasing capital. It adds to the cumulative conservatism in the Basel II rules. When an institution does an excellent job in measuring and managing credit, market, interest rate, operational and other conceivable risks, then its examiners should not automatically increase the capital requirement through ICAAP. More importantly, the supervisory standard needs to consider the most important capital a bank has against unexpected challenges: the capacity of management to react. The fact that most institutions normally hold more capital than the regulatory minimum does not justify the proposed concept. Instead, regulators should view the excesses as institutions use them, as strategic reserves for unforeseen opportunities, such as investments or acquisitions.

- **Paragraph 8** should not compel an ICAAP to justify an amount of excess capital in all circumstances. The provision states: "Generally, material increases in risk that are not otherwise mitigated should be accompanied by commensurate increases in capital." Bankers understand that an increase in an institution's risk profile (the inherent risk of its mix of business) should lead to commensurately more capital. However, they do not agree that a change in the economic environment should automatically trigger an increase in capital. Management should build up a buffer of capital in the institution during unstressed times to anticipate such periods. The capital buffer – the first line of defense – would not serve its purpose if it must be maintained during stress times. Thus the ICAAP should assess the institution's ability to remain appropriately capitalized during adverse conditions, using stress testing and other devices to evaluate the need for buffer capital.

- **Paragraph 15** should recognize that some types of risks have not yet been effectively modeled, and that capital is not the primary means to deal with some risks. The paragraph would require a thorough identification of all material risks, measurement of those that can be reliably quantified, and systematic assessment of all risks and their implications for capital adequacy. Paragraph 20 lists some of the risks that should be considered, including strategic and reputational risks. While some types of risks have been put to quantitative measurement, others have not. For example, at this point there are no established ways to measure strategic or reputational risk. Thus, capital for these types of risk will not come out of an ICAAP model. Moreover, some types of risk, such as reputational risk, exist whatever the level of capital. Therefore, an assessment of the implication for capital adequacy seems misguided. Other types of risk, such as liquidity risk, are better covered by a liquidity plan and liquidity backstops, rather than maintenance of capital. Thus the Guidance should specify that the ICAAP should assess the implications for capital adequacy only "where appropriate."

- **Paragraphs 29 and 30** discuss the need for stress testing an institution's ICAAP models. While testing a model's performance in stressed situations is an essential element of model validation, its relevance to determination of capital needs is unclear. Institutions cannot possibly hold enough capital to cover all conceivable, extreme scenarios. More critically, management uses stress testing to evaluate what can happen in various crises, and to prepare to react effectively. Supervisors should review an institution's stress testing for modeling and emergency preparedness, and discuss with management the role of capital in response to stress situations.

- **Paragraph 39.** An institution should not be required to use its ICAAP model throughout its business decision-making, as proposed in paragraph 39. The paragraph specifies that "management should be able to demonstrate that the ICAAP influences business decisions and overall risk management, and is not simply a compliance exercise. An ICAAP should influence decision-making at both the consolidated and individual business-line levels." Certainly, every institution using the Advanced Approaches will seek to align its ICAAP with its calculation of economic capital, so as to improve the ICAAP and make it more than a compliance exercise. If successful, the ICAAP could be used as proposed. However, when supervisors require something different in the ICAAP than the internal economic capital calculation, the ICAAP will not be the appropriate basis for business decisions. In such cases, specification that management should use the ICAAP means that the supervisory judgment should be taken in preference to that of management in making business decisions. This is clearly wrong.

V. Conclusion

ABA remains firmly in support of adoption of Basel II in this country. We encourage the Agencies to align the Advanced Approaches more closely with the Framework and finalize the rule and the Supervisory Guidances expeditiously. This process should similarly include development of the Standardized Approaches from the Framework and Basel IA to go along with the current "Basel I" in a menu of risk-based capital standards to suit the diversity of the U.S. banking industry.

Given the complexity of the proposal and the number of questions that we have addressed, we invite the staff of the Agencies to contact the undersigned if they have any questions about our comments.

Sincerely,

Robert W. Strand
Senior Economist

Paul Alan Smith
Senior Counsel