

THE FINANCIAL SERVICES ROUNDTABLE



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BITS

FINANCIAL SERVICES
R O U N D T A B L E

October 27, 2008

Via email at regs.comments@occ.treas.gov

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**Re: OCC-2008-0006: Risk-Based Capital Guidelines; Capital Adequacy Guidelines:
Standardized Framework Proposed Rule and Notice**

Dear Sir or Madam:

The Financial Services Roundtable, including its operations division BITS, ("Roundtable")¹ appreciates this opportunity to comment on the joint notice of proposed rulemaking ("NPR") to establish a new risk-based capital framework for U.S. depository institutions and bank holding companies ("banking organizations"). This proposed framework is based on, but is not the same as, the Standardized Approach for credit risk found in the Basel II Capital Accord, which was adopted by the Basel Committee on Bank Supervision in June 2004.

We believe that the proposal provides a significantly more risk sensitive capital standard than the one currently used by banking organizations, *e.g.* the Basel I standard. It better aligns regulatory

¹ The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic engine accounting directly for \$18.3 trillion in managed assets, \$678 billion in revenue, and 2.1 million jobs. BITS is a division of the Roundtable, leveraging intellectual capital to address issues at the intersection of financial services, operations and technology. BITS focuses on strategic issues where industry cooperation serves the public good, such as fraud prevention, critical infrastructure protection, and the safety of financial services.

capital requirements with risk, thereby enhancing the safety of our financial institutions. It rewards the use of conservative underwriting standards and risk mitigation techniques, and it enhances the availability of loans to creditworthy individuals and companies. All are important goals of regulatory policy, and they also are particularly important in the current economic situation in which tight credit threatens the ability of our economy to grow.

While we are highly supportive of the proposal, there are a number of areas in which we recommend further adjustment.

I. Additional Flexibility

The International Basel II Accord provides banking organizations (of any size) with several options, including the Standardized Approach. The NPR, on the other hand, generally limits the Standardized Approach to “non-core” banking organizations, which are banking organizations that are not required to use the Basel II Advanced Approach. In light of the recent turmoil in the financial markets, it is likely that the Basel Committee will review the International Accord to determine if any adjustments are needed. As part of this process, we believe that the agencies should consider incorporating some of the features of the U.S. Standardized Approach. This could enhance the risk sensitivity of capital requirements through the use of objective and observable risk characteristics. In addition, if the Basel II Committee does make changes to the new framework, it is critically important that the resulting rules are uniformly applicable across national boundaries, so that financial institutions are subject to the same rules globally.

Under the Basel II Advanced Approach a core bank may exclude certain immaterial exposures from its internal models, and hold capital for these exposures based on the Basel I rules. We recommend that capital requirements for these exposures should be determined pursuant to the Standardized Approach. In addition, we believe that the Standardized Approach is the appropriate framework to be used during transition periods, for example, the period during which a core bank has not yet fully implemented the Advanced Approach, and the period of adjustment following a merger or large acquisition.

The NPR provides that, except for bank holding companies with \$500 million or less in consolidated assets, a bank holding company and all of its subsidiary depository institutions must use the same capital framework. This requirement does not apply to insured institution subsidiaries of savings and loan holding companies. A bank holding company may have a variety of depository institution subsidiaries, and the same capital framework may not be appropriate for all. For some subsidiaries, the additional administrative costs of complying with the Standardized Approach may not justify its implementation, but this should not result in inhibiting its sister depository institutions from adopting the newer standard. Any concern that the holding company could use this flexibility to “arbitrage” the differences in the capital frameworks is mitigated by the fact that the holding company capital level will be determined by consolidating all of the assets in the banking organization and risk weighting these assets under one standard.

Finally, the NPR generally provides that the Standardized Approach will be an option, and not mandated. This is critically important, especially for institutions that are more than well capitalized under the existing rules and would find it very costly to comply with the new standard.

However, the proposal also states that in certain circumstances the appropriate regulator may require the use of the Standardized Approach, or may prohibit a bank from using this framework. If this provision is retained, the criteria under which the regulator may take such action must be clearly set forth. Determinations made under this authority must be explained, and should be subject to an agency review process. Arbitrary cut off points, such as a minimum asset size, should not be established.

II. Principle of Conservatism

The NPR provides that, in some cases, a banking organization may choose not to use the new framework for a particular class of assets, provided that applying the Basel I standard will, in all cases, result in a higher capital requirement than under the Standardized Approach *and* the exposures involved are not material.

For many institutions, the option to use the Basel I standard for a particular class of assets, and the Standardized Approach for the remainder of the bank's assets, not only makes sense, but in fact makes it possible to adopt the new framework. However, the NPR unnecessarily limits the flexibility of a banking organization to take this approach. Under the proposal, use of the Basel I standard is only allowed if the exposures involved are non-material. However, since the rule requires that the Basel I standard result in a *higher* capital charge, there is no reason to limit it to non-material assets. True flexibility can be achieved by removing this unnecessary limitation.

III. NRSRO Credit Ratings

Under the proposal, a banking organization would use credit ratings issued by a nationally recognized statistical rating organization ("NRSRO") to determine the risk weight for a broad range of exposures. The NPR specifically asks for comment on the use of NRSRO ratings and if refinements in the rule are necessary to ensure the prudent use of such ratings.

The banking agencies, the President's Working Group on Financial Markets, Basel Committee on Banking Supervision, the Financial Stability Forum, and numerous other regulatory bodies have expressed concerns about the credit rating process in recent months. On September 29, 2006 the Congress enacted the Credit Rating Agency Reform Act,² which authorized the SEC to issue rules to govern the operations of these organizations (other than rating methodologies). The SEC issued its first set of regulations in 2007,³ and in July 2008⁴ proposed a second set of regulations to significantly enhance the transparency of the rating process and address concerns about inherent conflicts of interest. We believe that these reforms will likely improve the reliability and transparency of credit ratings. Based on this conclusion, we believe continued reliance on the credit ratings, coupled with a banking organization's independent evaluation of the credit quality of a counterparty or instrument, provides a far better basis for capital allocation than any currently available alternative. In addition, as will be discussed below, we believe that other criteria, such as loan-to-value ratios, can also provide an objective indication of credit risk.

² Public Law 109-291 (2006).

³ 72 Fed. Reg. 33564 (June 18, 2007).

⁴ 73 Fed. Reg. 40124 (July 11, 2008).

IV. Government Guaranteed Exposures

The NPR assigns a risk weight to exposures guaranteed by a sovereign based on the credit rating of the Government. If the rating is the first or second highest investment grade rating, the risk weight is 0. This is the risk weight applicable to the U.S.

The final regulation should clarify that obligations backed by the U.S. Government, including FDIC insured deposits and senior debt instruments, are risk weighted as U.S. Government exposures up to the limits of the Federal protection, including FDIC deposit insurance or guarantees of senior debt.

In addition, the risk weight assigned to Fannie Mae, Freddie Mac and Federal Home Loan Bank debt should take into account the recent legislation that provides explicit Treasury backing for these entities.

V. Corporate Exposures

The NPR authorizes banking organizations to either risk weight all corporate exposures at 100 percent, or to assign a risk weight to corporate exposures of 20, 50, 100 or 150 percent depending on NRSRO credit rating. Below investment grade exposures would receive a risk weight of 150 percent. Unrated exposures would be risk weighted at 100 percent.

We agree that credit ratings, coupled with the banking organization's independent evaluation of credit risk, provide a useful tool for risk weighting assets. However, the proposal would be improved by expanding the number of risk-weight baskets to better reflect the different credit risks posed by different exposures. A more refined approach, for example, would include 10 percent, 35 percent and 75 percent baskets in addition to the four baskets suggested in the proposal.

In addition, we believe that other objective criteria can also play a role in assigning risk weights for corporate exposures, and would make it possible to more finely differentiate credit risk. For example, for loans used to purchase equipment or to finance the acquisition of property, the loan-to-value ratio could be used to assign risk weights where there is no NRSRO rating.

VI. Retail Exposures

The NPR provides that retail exposures will be subject to a 75 percent risk weight if the following conditions apply: (i) the banking organization's total exposure to a single borrower does not exceed \$1 million; (ii) the exposure is part of a well diversified portfolio; and (iii) the exposure does not fall into another category, such as a mortgage exposure.

In our view, while this is basically a sound proposal for the risk weighting of retail credits, additional clarifications are needed. We recommend that the proposal provide additional guidance on the meaning of the term "well diversified." Such guidance should make it clear that geographic diversification is not the goal, since many banks specialize in serving local markets. In addition, we note that under the International Accord, retail exposures include loans to individuals for up to \$1.34 million

based on current exchange rates. We suggest increasing the cap on retail loans to at least \$1.25 million to better align our rules with the International Accord.

VII. Residential Mortgage Exposures

The NPR assigns risk weights for residential mortgage exposures based on loan-to-value ratios, and whether the loan is secured by a first or more junior lien. In calculating the loan-to-value ratio, a banking organization may take into account loan level private mortgage insurance, provided the insurance company is not an affiliate, and its long-term senior debt or claims paying ability is rated in one of the three highest categories.

The Roundtable supports this approach for residential mortgage loans. Loan-to-value ratios have consistently been shown to be the best indicator of loan quality.⁵ In light of the proven correlation between loan-to-value ratios and credit risk, we do not believe it necessary to use other factors, such as the borrower's credit score, which would add unnecessary complexity to the rule.

We also note that the proposal recognizes loan level private mortgage insurance. Such insurance protects the lender from the risks of default, and also provides an independent third party evaluation of the exposure. It is therefore entirely appropriate to take such insurance into account. However, the proposal does not consider pool level private mortgage insurance, and we think it would be appropriate to do so.

VIII. Credit Risk Mitigation

The NPR recognizes various forms of credit risk mitigation, including third party guarantees, collateral, and netting agreements. The Roundtable supports this approach, and believes that it will result in a closer alignment of required capital and risk. It will also encourage banking organizations to use credit risk mitigation techniques.

The NPR provides for three methods for adjusting the risk weight of an exposure that is supported by eligible collateral. However, the NPR would not permit the use of all of the adjustments authorized by the International Accord. We believe that the proposal should permit qualified banking organizations to use some of the more sophisticated methods that are available under the Accord, and that are available to financial institutions abroad. In particular, we believe that the so-called "Zero H Approach," which permits a banking organization to recognize the risk mitigation value of certain repurchase agreements without a haircut, should be available to eligible U.S. banking organizations. We also believe that internal models, such as expected positive exposure ("EPE"), should be available to banking organizations that have the capability of using these models. To alleviate supervisory concerns, the use of these models could be conditioned on prior regulatory approval.

⁵ See, e.g. Min Qi and Xialong Yang, "Loss Given Default of High Loan-to-Value Residential Mortgages," Office of the Comptroller of the Currency, Economics and Policy Analysis Working Paper 2007-4 (August 2007); Paul Calem and Michael LaCour-Little, "Risk-Based Capital Requirements for Mortgage Loans," *Journal of Banking & Finance* 28, 647-672 (2004).

IX. Operational Risk

Operational risk refers to the risk of loss to a banking organization from inadequate or failed internal process, people, systems, or from external events. This includes legal risks, as well as the risks of natural or man-made disasters.

While the International Accord provides for three alternative methods of allocating capital for operational risk, the NPR recognizes only one method, the so-called "basic indicator approach," ("BIA"). The BIA is a "blunt tool." Capital for operational risk would be arbitrarily calculated as 15 percent of the banking organization's average positive gross income over the past three years.

While the BIA may be appropriate for smaller or less sophisticated banking organizations, it must be acknowledged that the correlation between positive gross income and operational risk is strained at best. In fact, organizations with higher positive gross income may have the resources to employ more elaborate methods of controlling operational risk, yet under the basic indicator approach, would receive no recognition for these efforts. Further, the BIA does not take into account insurance, internal controls, and other risk mitigants that unquestionably reduce operational risk. We strongly recommend, therefore, that the final regulation permit banking organizations to use any of the three methods of measuring and computing an operational risk capital charge, including the BIA, the Alternative Standardized Approach ("ASA") and the Advanced Management Approach ("AMA").

X. Use of GAAP in Calculation of Risk-Weighted Assets

Under Section M, Risk-Weighted Assets for Securitization Exposures, the NPR states, "a banking organization that engages in a traditional securitization would exclude the underlying exposures from the calculation of risk-weighted assets only if each of the following conditions are met: (i) the transfer is a sale under GAAP; (ii) the originating banking organization transfers to one or more third parties credit risk associated with the underlying exposures; and (iii) any clean-up calls relating to the securitization are eligible clean-up calls."

We are concerned that with the proposed FAS 140 changes, ordinary course securitizations may no longer meet sale accounting treatment. We, therefore, urge the Agencies to reassess the need for sale treatment to serve as a prerequisite for capital relief, as they have indicated they would do should "GAAP...materially change". Given that this potential change to the interpretation of sale accounting does not reflect any change in the transfer of risk, there is no reason why capital requirements should be modified. Additionally, as neither Basel II nor the EU's Capital Requirements Directive includes accounting sale treatment as a requirement for ordinary course securitizations, forcing a linkage between GAAP and capital requirements in this instance could result in competitive issues for U.S. banks.

Conclusion

The Roundtable strongly supports the development of a U.S. version of the Standardized Approach for risk-based capital. The proposal will far better align capital requirements with risk. As a result, banking organizations that take a less risky and more conservative approach will receive capital relief, and organizations that take a more risky approach will hold higher capital to support their more

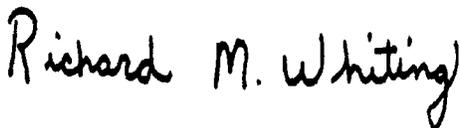
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risky investments. In addition, a more risk sensitive capital framework will permit less risky institutions to increase their lending activities, which is currently a critically important need in our economy.

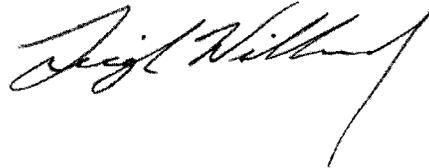
While the Roundtable supports the proposal, there are a number of areas in which it can be improved. The changes suggested in this letter would enhance the risk sensitivity of the proposal and would permit U.S. banking organizations to use additional options that are included in the International Accord and available to foreign banks. The increased flexibility would encourage more banking organizations to use the Standardized Approach, which will benefit our economy and bank safety and soundness.

If you have any questions about this letter, or any of the issues raised by our comments, please do not hesitate to call us at (202) 289-4322.

Sincerely,



Richard M. Whiting
Executive Director and General Counsel
The Financial Services Roundtable



Leigh Williams
President
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