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January 18, 2006

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
ATTN: Docket No. 05-16

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
ATTN: Docket No. R-1238

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2005-40

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications

Ladies and Gentlemen:

The Risk Management Association ("RMA")[1] appreciates the opportunity to comment on the Advance Notice of Proposed Rulemaking ("ANPR") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (together, the "Agencies") regarding proposed revisions to the Agencies' existing domestic risk-based capital rules that will apply to the vast majority of banking organizations in the United States ("U.S."). This letter responds to the Agencies' request in the ANPR for broad comment on possible modifications to their risk-based capital standards that would facilitate the development of fuller and more comprehensive proposals applicable to a range of banking organization activities and exposures. RMA wishes to express its appreciation for the Agencies solicitation of broad based comments and suggestions at this stage of the process, and we have endeavored to respond accordingly.

As you may know, the RMA Capital Working Group has been actively involved in the effort to reform the capital guidelines for the largest institutions in the U.S., known as Basel II. Indeed, RMA has long argued that capital requirements should be more closely aligned to

[1] Founded in 1914, RMA is a not-for-profit, member driven professional association whose sole purpose is to advance the use of sound risk practices in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, and operational risk. RMA's membership consists of more than 3,000 financial services providers, and 16,000 risk management professionals who are chapter members in financial centers throughout North America, Europe, and Asia/Pacific.

risk and is pleased that the U.S. regulatory agencies are undertaking reform of the capital guidelines for all institutions.

RMA's membership is diverse, much like the U.S. banking industry itself, and in responding to the ANPR, we have attempted to solicit opinion from all sectors of the industry. For this reason, our response to the ANPR consists of three separate appendices, each of which represents a particular industry sector to which the revised risk-based capital guidelines might apply in some fashion.

Appendix A: To solicit industry commentary from community banking organizations, RMA conducted a web-based opinion survey, the results of which can be found in Appendix A. RMA received 120 responses to the survey, with 78 percent of the respondents representing institutions with less than $1 billion in assets. For institutions responding to the survey, 57 percent were familiar with the proposed revisions to risk-based capital guidelines outlined in the ANPR. Interestingly, 58 percent of the respondents stated that, "the guidelines will not materially impact my institution," while 20 percent opposed adoption of the revisions proposed in the ANPR. Nonetheless, 87 percent of respondents believed that alternate capital requirements and approaches to calculating risk-based capital should be based on the complexity of the institution, and 86 percent felt that there should be an asset size threshold below which banking organizations would be allowed to apply the existing risk-based framework if they so choose. The RMA Community Bank Council also reviewed the ANPR in considerable detail and unanimously agreed that institutions should have the option to remain under the current capital framework.

Appendix B: On October 11, 2005, RMA convened a group of member institutions to discuss the ANPR, and that group has continued meeting via teleconference to develop a response to the ANPR, which is included as Appendix B.[2] As you can see, institutions represented in the group are not required to adopt the AIRB approach contained within Basel II and most were not planning to opt-in to the advanced framework, although all employ internal risk rating systems that distinguish between obligor and facility ratings, and many have, or are developing, estimation methodologies to determine the probability of default (PD) for various portfolio exposures. Most have developed, or are in the process of developing, an enterprise risk management framework that assigns internal capital for risk exposures beyond purely credit risk. These institutions, by and large, did not believe that the ANPR provided a capital framework that was sufficiently risk sensitive. As a result, RMA is recommending an alternative to the ANPR that would encompass a multi-tier approach to risk-based capital guidelines as embodied in Appendix B. The RMA Alternative Approach was discussed during a Web-Seminar on December 8, 2005 that RMA held jointly with Goodwin Procter LLP.

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[2] Representatives from Amegy Bank, BB&T, Broadway National Bank, City National Bank, Commerce Bank, Frost Bank, Manufacturers & Traders Trust Co., Regions Financial Corporation, Sovereign Bank, Sterling Bank, Summit Bank, Susquehanna Bancshares, United Community Bank, and Webster Bank attended the October 11, 2005 meeting.

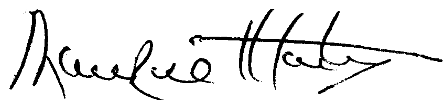
Appendix C: The RMA Capital Working Group (CWG) was established in 1999 to provide industry commentary on the various consultative papers that comprised the initial reform of the 1988 Basel Accord, commonly known as Basel II. The CWG remains very active and has conducted industry research and provided extensive commentary around best practice economic capital estimation practices and procedures. Members of this group will be required to adopt the AIRB Basel II approach or are planning to opt-in to the framework, and believe that the use of the ANPR framework as a possible floor for AIRB banks would be unnecessarily burdensome. Like the banks responding in Appendix B, this group as well is recommending a multi-tier approach to better align the risk-based capital guidelines more appropriately to risk sensitivity. CWG members are also committed to continuing to work with the regulatory agencies regarding on-going implementation of Basel II without further delay and believe that a more risk sensitive framework for non-AIRB banks should, and can, be adopted within a similar timeframe.

Summary Recommendations: There are a number of institutions that would not derive any material benefit from moving to a more risk sensitive capital framework and RMA recommends strongly that institutions have the option to remain under the existing risk-based capital guidelines. For institutions that have, or are developing, more risk sensitive measurement and management frameworks, RMA believes that a multi-tier approach to risk-based capital guidelines is necessary to ensure that capital regulations are appropriately risk sensitive and that such regulations continue to evolve over time as best practice within the industry is enhanced. To facilitate the development of such a multi-tier approach, RMA recommends that an industry/inter-agency task force be created to work jointly to develop appropriate risk parameter specifications for risk-based capital guidelines. Moreover, RMA believes that an industry/inter-agency task forces must be established to resolve on-going implementation issues surrounding Basel II.

As always, RMA is ready to assist the regulatory agencies in any way that you may deem appropriate, but would recommend strongly that an industry/inter-agency task force be formalized to assist further in the development of a multi-tier approach to risk-based capital guidelines, in addition to continuing to work with the regulatory agencies regarding on-going implementation of Basel II. This approach would be far preferable to the existing procedure, which results in long lapses of time as the regulatory agencies draft regulatory guidance and then involve the industry for review and comment.

Again, RMA appreciates the opportunity to offer commentary on the ANPR and would be happy to answer any questions you may have.

Very Sincerely,



RMA Community Bank Survey

Response to the ANPR for proposed revisions to the U.S. risk-based capital guidelines

Summary Overview:

A total of 120 respondents took part in this survey during November-December 2005. Via the survey, RMA sought input on the proposed changes to the existing risk-based capital framework as proposed by the U.S. regulatory Agencies in an ANPR published in the Federal Register on October 20, 2005.

The proposed framework attempts to address issues of competitive equity that have arisen in conjunction with the implementation of Basel II, a new risk-based capital framework that is being applied to the largest global institutions. Participants were informed that the information collected in this survey would aid RMA in forming its response to the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve System regarding the proposed changes.

In the interest of time, the final report's presentation style is oriented toward showing overall aggregate results emphasizing the communication of facts over analysis. RMA staff members contributing to the study were Bill Githens, Pamela Martin, Mark Zmiewski, and Suzanne Wharton. The writing of the final report was undertaken by RMA.

DISCLAIMER

All the information contained herein is obtained from sources believed to be accurate and reliable. All representations contained herein are believed by RMA to be as accurate as the data and methodologies will allow. However, because of the possibilities of human and mechanical error, as well as unforeseen factors beyond RMA's control, the information herein is provided "as is" without warranty of any kind. RMA makes no representations or warranties express or implied to participants in the study or any other person or entity as to the accuracy, timeliness, completeness, merchantability, or fitness for any particular purpose of any of the information contained herein. Furthermore, RMA disclaims any responsibility to continue to update the information. Moreover, information is provided without warranty on the understanding that any person or entity that acts upon it or otherwise changes position in reliance thereon does so entirely at such person's or entity's own risk.

What were your institution's assets as of 6/30/2005?

Response	Count	Percent
< $250 million	50	43.9%
$251 - $500 million	24	21.1%
$501 - $750 million	9	7.9%
$751 million - $1 billion	6	5.3%
$1 - $4.9 billion	23	20.2%
$5 - $9.9 billion	1	0.9%
$10 - $24.9 billion	1	0.9%

What is your primary functional title?

Response	Count	Percent
CEO	13	11.5%
President	6	5.3%
Chief Financial Officer	12	10.6%
Chief Risk Officer	5	4.4%
Senior Credit Officer	24	21.2%
Senior Lending Officer	13	11.5%
Chief Credit Officer	32	28.3%
Chief Compliance Officer	1	0.9%
Other	7	6.2%

"Other" responses:

- Credit Manager
- Risk Management Analyst
- V.P. Lending (2)
- Credit Administration
- Commercial Loan Officer
- CEO & President
- Staff Accountant
- Risk Analyst

In what region is your predominant C&I and CRE exposure?

Response	Count	Percent
Nationwide	1	0.9%
Midwest	51	44.3%
Northeast	42	36.5%
South	18	15.7%
Southwest	21	18.3%
West	22	19.1%

How knowledgeable are you about Basel 1A?

	Overall		<$250MM		$251MM-$1B		>$1 B	
Response	**#**	**%**	**#**	**%**	**#**	**%**	**#**	**%**
I'm familiar with it	66	57.4%	27	54.0%	20	51.3%	19	76.0%
I'm not familiar with it	8	7.0%	3	6.0%	4	10.3%	1	4.0%
I don't understand it's implications for my bank	20	17.4%	11	22.0%	6	15.4%	3	12.0%
I don't know if it is relevant for my bank	28	25.3%	14	28.0%	11	28.2%	3	12.0%
Other	2	1.6%	0	0.0%	0	0%	2	8.0%

Based on your reading and understanding of the advanced notice of proposed rulemaking (ANPR) on revised risk-based capital guidelines -"Basel 1A", what is your institution's level of support for it?

	Overall		<$250MM		$251MM-$1B		>$1 B	
Response	**#**	**%**	**#**	**%**	**#**	**%**	**#**	**%**
Full support as presented	9	7.9%	3	6.0%	4	10.3%	2	8.0%
Support if the following conditions are met/changes are made:	10	7.9%	2	4.0%	4	10.3%	4	16.0%
▪ That the option to remain under the old rules is available to smaller organizations which may not be able to bear the additional administrative cost of Basel 1A.								
▪ Assure that compliance will not be prohibitive in costs and that it makes logical sense for a small community bank.								
▪ Extensive implementation timeline since system would have to be significantly modified to automate the risk rated weight.								
▪ The categories of risk are realistic, and do not create a reporting nightmare.								
▪ Ok, if the targeted capital levels are similar to Basel II.								
▪ Some of the detail required in the analysis of assets being reported will require more sophisticated programming than many of the smaller banks currently have. The theory is great, but for smaller institutions the reporting will be a burden.								
Opposed	23	20.2%	10	20.0%	5	12.8%	8	32.0%
The guidelines will not materially impact my institution, so we are not focused on it	66	57.9%	35	70.0%	22	56.4%	9	36.0%
Other	6	6.1%	0	0.0%	4	10.3%	2	8.0%

"Other" responses:

- Have not yet assessed impact. (3)
- I do not want to have to ongoing requirements to monitor market LTVs.
- Undecided at this time.
- May have some level of support. Appears to be needlessly arcane. Suspicious that this may be a ploy by large national and international Banks to ultimately lower pricing (less capital cost component in pricing) at our expense.
- The reporting requirements appear onerous. We would probably endorse maintaining the existing risk-based capital requirements.

Other Comments:

- We have a 1-8 asset quality grading system that identifies specific allocations for loans that require additional reserves due to collateral shortages or other reasons.
- We would like to see the option to use our internal risk rating system in some way.

In considering revisions to the domestic risk-based capital rules, the Agencies were guided by five broad principles. Please rate the degree to which you feel the revised framework meets those principles. (1 means the principle is fully met, 3 means the principle is somewhat met and somewhat not met, and 5 means the principle is not met at all.

Participants rated the degree to which they felt the revised framework meets the five guiding principles on a 1-5 scale with 1 being fully meets.

Overall Rating:

	Meets the Principle
Principle 1	2.8
Principle 2	3.3
Principle 3	3.9
Principle 4	3.2
Principle 5	3.3

Principle 1: The revisions promote safe and sound banking practices and a prudent level of regulatory capital.
Overall: 2.8 (with 1 being fully meets and 5 being does not meet at all.)

Response	Count	Percent
1 (fully meets)	4	8.5%
2	17	36.2%
3	14	29.8%
4	10	21.3%
5 (does not meet at all)	2	4.3%

Comments:

- Our current system already meets the principal.
- The ANPR has good principles behind it. If a bank has less risk, you should be required to have less capital. The application of the theory leaves a little to be desired.
- Fancy math for less capital spells trouble.
- I am not sure that it is a great deal of value for banks under $500M.
- External credit ratings seem to lag actual risk exposure. Appraisers have wide latitude in their assumptions and can be quite subjective. The degree to which non-accrual loans have already been written-down varies greatly from bank to bank.

Principle 2: The revisions maintain a balance between risk sensitivity and operational feasibility.
Overall: 3.3 (with 1 being fully meets and 5 being does not meet at all.)

Response	Count	Percent
1 (fully meets)	2	4.3%
2	12	25.5%
3	8	17.0%
4	21	44.7%
5 (does not meet at all)	4	8.5%

Comments:

- It appears the additional breakdown of risk components is too burdensome. The determination of the risk level of the bank and its capital should be determined during an onsite exam. The proposed rules would be hard to enforce.

Principle 3: The revisions avoid undue regulatory burden.
Overall: 3.9 (with 1 being fully meets and 5 being does not meet at all.)

Response	Count	Percent
1 (fully meets)	1	2.1%
2	6	12.8%
3	8	17.0%
4	12	25.5%
5 (does not meet at all)	20	42.6%

Comments:

- How would regulators catch any discrepancies?
- It will add more burden for small banks. (2)
- I suppose if you can afford it, it’s not a burden

Principle 4: The revisions create appropriate incentives for banking organizations.
Overall: 3.2 (with 1 being fully meets and 5 being does not meet at all.)

Response	Count	Percent
1 (fully meets)	1	2.1%
2	8	17.0%
3	17	36.2%
4	15	31.9%
5 (does not meet at all)	6	12.8%

Comments:

- If a bank is not determining these types of risks, they should have additional capital.
- Not all incentives are healthy for the banking industry.

Principle 5: The revisions mitigate material distortions in the risk-based capital requirements for large and small institutions.
Overall 3.3 (with 1 being fully meets and 5 being does not meet at all.)

Response	Count	Percent
1 (fully meets)	2	4.3%
2	12	25.5%
3	11	23.4%
4	12	25.5%
5 (does not meet at all)	10	21.3%

Comments:

- The large bank small bank argument is operational; not risk based. We can't spread this cost out or hire the staff to implement it without serious ROA implications.
- More regulations favor larger institutions.
- Large banks will get by with lower equity requirements--possibly for similar products.

In considering revisions to the domestic risk-based capital rules, the Agencies are seeking input on nine proposals that will impact capital. We asked participants to rate the degree to which the proposals will benefit the industry. (1 means it fully benefits the industry, 3 means it is somewhat beneficial to the industry, and 5 means it does not benefit the industry at all.) In addition, participants rated the ease of implementation of the nine proposals, with 1 meaning it will be easy to implement, and so forth.
Overall Rating:

	Benefits the industry	Ease of implementation
Proposal 1	3.0	3.7
Proposal 2	3.6	3.2
Proposal 3	2.8	3.3
Proposal 4	2.6	3.4
Proposal 5	3.0	3.2
Proposal 6	2.7	2.5
Proposal 7	3.2	3.2
Proposal 8	2.8	3.7
Proposal 9	3.5	3.8

Proposal 1: The Agencies are considering increasing the number of risk-weight categories from five to nine to which credit exposures may be assigned.
Overall: 3.0 (with 1 being fully benefits and 5 being does not benefit at all.)

Response	Count	Percent
1 (fully benefits)	4	8.5%
2	17	36.2%
3	10	21.3%
4	5	10.6%
5 (does not benefit)	11	23.4%

Ease of implementation: **Overall 3.7** (with 1 being easy to implement and 5 being difficult to implement).

Response	Count	Percent
1 (easy to implement)	2	4.3%
2	2	4.3%
3	18	38.3%
4	12	25.5%
5 (difficult to implement)	13	27.7%

Comments:

- We already have 8 as well as specific allocations for special problem loans.
- Will depend on our data processor changes
- For smaller banks with fewer resources this could be a problem. (2)

Proposal 2: The Agencies are considering expanding the use of external credit ratings as an indicator of credit risk for externally rated exposures.
Overall: 3.6 (with 1 being fully benefits and 5 being does not benefit at all.)

Response	Count	Percent
1 (fully benefits)	2	4.3%
2	8	17.0%
3	12	25.5%
4	10	21.3%
5 (does not benefit)	15	31.9%

Ease of implementation: **Overall 3.2** (with 1 being easy to implement and 5 being difficult to implement).

Response	Count	Percent
1 (easy to implement)	3	6.5%
2	12	26.1%
3	13	28.3%
4	8	17.4%
5 (difficult to implement)	10	21.7%

Comments:

- How accurate?
- The majority of smaller banks will not have customers with external credit ratings. (4)

Proposal 3: The Agencies are considering expanding the range of collateral and guarantors that may be used to qualify an exposure for a lower risk weight.
Overall: 2.8 (with 1 being fully benefits and 5 being does not benefit at all).

Response	Count	Percent
1 (fully benefits)	6	12.8%
2	19	40.4%
3	10	21.3%
4	3	6.4%
5 (does not benefit)	9	19.1%

Ease of implementation: **Overall 3.3** (with 1 being easy to implement and 5 being difficult to implement).

Response	Count	Percent
1 (easy to implement)	3	6.4%
2	10	21.3%
3	12	25.5%
4	14	29.8%
5 (difficult to implement)	8	17.0%

Comments:

- Hard to implement on the loan side.
- Granularity is nice but it is difficult to measure without significant resources. Small banks just can't afford all this and it creates an uneven playing field.

Proposal 4: The Agencies are considering using loan-to-value ratios, credit assessments such as credit scores, and other broad measures of credit risk for assigning risk weights to residential mortgages.
Overall: 2.6 (with 1 being fully benefits and 5 being does not benefit at all).

Response	Count	Percent
1 (fully benefits)	4	8.7%
2	23	50.0%
3	11	23.9%
4	4	8.7%
5 (does not benefit)	4	8.7%

Ease of implementation: **Overall 3.4** (with 1 being easy to implement and 5 being difficult to implement).

Response	Count	Percent
1 (easy to implement)	3	6.5%
2	11	23.9%
3	6	13.0%
4	17	37.0%
5 (difficult to implement)	9	19.6%

Comments:

- Don't we already do this?
- Expensive

Proposal 5: The Agencies are considering modifying the credit conversion factor for various commitments, including those with an original maturity of under one year. Overall: 3.0 (with 1 being fully benefits and 5 being does not benefit at all).

Response	Count	Percent
1 (fully benefits)	5	10.9%
2	8	17.4%
3	20	43.5%
4	7	15.2%
5 (does not benefit)	6	13.0%

Ease of implementation: **Overall 3.2** (with 1 being easy to implement and 5 being difficult to implement).

Response	Count	Percent
1 (easy to implement)	3	6.5%
2	10	21.7%
3	12	26.1%
4	16	34.8%
5 (difficult to implement)	5	10.9%

Proposal 6: The Agencies are considering requiring that certain loans 90 days or more past due or in a non-accrual status be assigned to a higher risk-weight category. Overall: 2.7 (with 1 being fully benefits and 5 being does not benefit at all).

Response	Count	Percent
1 (fully benefits)	3	6.5%
2	23	50.0%
3	10	21.7%
4	4	8.7%
5 (does not benefit)	6	13.0%

Ease of implementation: **Overall 2.5** (with 1 being easy to implement and 5 being difficult to implement).

Response	Count	Percent
1 (easy to implement)	15	32.6%
2	15	32.6%
3	12	26.1%
4	4	8.7%
5 (difficult to implement)	0	0.0%

Comments:

- What will collateral do to rating?
- We already code all 90 day past dues as substandard and automatically place the loan in non-accrual status.

Proposal 7: The Agencies are considering modifying the risk-based capital requirements for certain commercial real estate exposures such as acquisition, development, and construction (ADC) loans based on longstanding supervisory concerns with many of these loans.

Overall: 3.2 (with 1 being fully benefits and 5 being does not benefit at all).

Response	Count	Percent
1 (fully benefits)	2	4.3%
2	14	30.4%
3	11	23.9%
4	9	19.6%
5 (does not benefit)	10	21.7%

Ease of implementation: **Overall 3.2** (with 1 being easy to implement and 5 being difficult to implement).

Response	Count	Percent
1 (easy to implement)	3	6.5%
2	11	23.9%
3	11	23.9%
4	14	30.4%
5 (difficult to implement)	7	15.2%

Comments:

- The market has gone overboard here.

Proposal 8: The Agencies are considering increasing the risk sensitivity of capital requirements for other types of retail, multifamily, small business, and commercial exposures, recognizing that a one-size-fits-all approach is not adequate.
Overall: 2.8 (with 1 being fully benefits and 5 being does not benefit at all).

Response	Count	Percent
1 (fully benefits)	2	4.3%
2	24	51.1%
3	11	23.4%
4	3	6.4%
5 (does not benefit)	7	14.9%

Ease of implementation: **Overall 3.7** (with 1 being easy to implement and 5 being difficult to implement).

Response	Count	Percent
1 (easy to implement)	1	2.2%
2	5	10.9%
3	13	28.3%
4	13	28.3%
5 (difficult to implement)	14	30.4%

Proposal 9: The Agencies are considering assessing a risk-based capital charge to reflect the risks in securitizations backed by revolving retail exposures with early amortization provisions.
Overall: 3.5 (with 1 being fully benefits and 5 being does not benefit at all).

Response	Count	Percent
1 (fully benefits)	1	2.2%
2	10	21.7%
3	12	26.1%
4	12	26.1%
5 (does not benefit)	11	23.9%

Ease of implementation: **Overall 3.8** (with 1 being easy to implement and 5 being difficult to implement).

Response	Count	Percent
1 (easy to implement)	0	0.0%
2	2	4.4%
3	18	40.0%
4	13	28.9%
5 (difficult to implement)	12	26.7%

The ANPR focuses on credit risk, with no explicit capital charges for operational risk or interest rate risk. Do you agree that there should be no explicit capital charge for operational risk or interest rate risk?

Response	Count	Percent
Yes, I agree for both operational risk and interest rate risk	16	34.0%
Yes, I agree for operational risk only	7	14.9%
Yes, I agree for interest rate risk only	2	4.3%
No, I do not agree	21	44.7%
Other	1	2.1%

"Other" responses:

- I'd rather the regulators allow us to make the decision on capital charges for operational and interest rate risk.
- Packing these risks into credit risk ignores the real world and gives no options to demonstrate how those risks might be mitigated.

The Agencies are not proposing revisions to the existing leverage capital requirement (the ratio of Tier 1 capital to total assets). Do you agree?

Response	Count	Percent
Agree	36	76.6%
Disagree	8	17.0%
Unsure (please provide comments)	3	6.4%
Other	0	0.0%

Comments:

- Depends on what will qualify as Tier I capital in the future.
- This is a one size fits all approach

Please indicate if you agree that there should be an asset size threshold below which banking organizations should be allowed to apply the existing risk-based capital framework if they so choose.

Response	Count	Percent
Yes	96	85.7%
No	11	9.8%
Unsure (please provide comments)	2	1.8%
Other	3	2.7%

"Other" responses:

- Could be uncompetitive with large banks
- Yes, unless new is better for bank
- Considering competitive issues
- $500 million
- QIS-4 results are now fully understood.
- CRA, markets available/not asset size

Should there be alternate capital requirements and approaches to calculating risk-based capital based on the complexity of the institution?

Response	Count	Percent
Yes	98	86.7%
No	14	12.4%
Unsure (please provide comments)	1	0.9%

Comments:

- Although this would be ideal, it would be a nightmare for regulators, rating agencies and the stock valuation companies to convert oranges, apples and pears to one standard for the industry

Do you intend to comment to the Agencies on this proposed change (Basel 1A)?

Response	Count	Percent
Yes	12	10.7%
No	88	78.6%
Unsure (please provide comments)	12	10.7%

Comments:

- We expect you to do this!
- I may write to them.
- I'll work with our banking PAC's and organizations to send their letters accordingly
- Hard to know impact relative to competition
- If it becomes helpful to join in comments to the Agencies we will.
- We are commenting through trade associations

Please provide any additional comments on Basel 1A that have not been addressed in this survey.

- It appears that regulators who have no other constraints on their time and resources desire certain information to justify their existence and want others to gather their information. It also seems that the need for expanded capital amounts will work negatively on the demands to meet the credit needs of all the community that has been their charge for several years.
- Basel II granulizes the loan portfolio in a much greater degree than has been done before. Not all banks will have the technical skills or resources to accomplish this. From what I have gathered, Basel II could drive down capital requirements. This could create an uneven playing field with non Basel II banks. The first interagency proposal for PD and LGD was far too simplistic. I am monitoring all of this unfold.
- The proposed ANPR does not seem to eliminate the capital break given the large banks even if more advance risk management practices are in place or being proposed. This runs contra to the concept of introducing more robust enterprise risk management. Since these risk management initiatives are expensive it makes it much harder to justify them if they are not recognized in the setting of capital requirements.
- None (2)

Response to the ANPR for Proposed Revisions to the U.S. Risk Based Capital Rules

I. Introduction

RMA agrees with the Agencies that revisions to the existing domestic risk-based capital rules are necessary in order to align risk with capital more effectively, and to address the competitive inequality that would otherwise arise upon implementation of the New Basel Capital Accord ("Basel II") in the U.S. for the largest, most internationally active U.S. banks. Furthermore, RMA acknowledges the need for a capital framework that assures that financial institutions maintain, at a minimum, levels of capital necessary to assure safe and sound operations. However, as discussed in more detail below, RMA believes that the measures proposed in the ANPR are inadequate to achieve the Agencies' objectives. Accordingly, RMA proposes broad revisions to the ANPR framework that would better align risk-based capital requirements with enhanced risk management techniques. Such an alternative is consistent with the spirit of the ANPR, the focus of the risk-based examination practices in place within the Agencies, and recent public comments by representatives of the Agencies.

A) *Shortcomings of the ANPR*

The ANPR makes it clear that the provisions it contains are intended for all 9,000 or so banking organizations in the U.S., other than the 10 to 20 largest U.S. banks, to which Basel II will initially apply. RMA believes that these proposed revisions might be suitable for only a subset of these institutions.

No single standard could meet the needs of so diverse a set of organizations. Today, there is a legitimate range of practice in U.S. banking regarding the estimation of capital requirements, capital allocation and other related activities that reflects legitimate differences in the business objectives, risk appetite, balance sheet composition and risk environment of different organizations. For some less complex institutions, the proposed framework would represent an uncalled for and significant regulatory burden. Indeed, for these simpler institutions, far from reducing the competitive concerns aroused by Basel II, it might exacerbate them. Moreover, a number of small, community bank organizations are privately held and would have no interest in developing the necessary infrastructure to comply with a new regulatory capital regime.

For some more complex institutions, the proposed framework is too simple. For example, the use of broad categories of risk to determine capital does not adequately measure the actual risk of many such institutions' activities. Specifically, the use of external credit ratings to assign regulatory capital will have no material impact upon capital levels at many institutions since the loan portfolios at such institutions do not contain a material portion of publicly rated debt.

As proposed, the ANPR does not sufficiently recognize nor promote improvement in risk management systems. By creating a single framework, the ANPR neither aligns risk with capital for many institutions, nor encourages enhanced risk management techniques, nor addresses adequately the industry's concerns about competitive inequality. As it stands, therefore, it does not meet its intended public policy objectives.

B) *Proposed Multi-Tier Approach*

To remedy these shortcomings, RMA, on behalf of its broad array of banking institution members, recommends that the Agencies adopt a multi-tier approach for the assignment of

regulatory capital. RMA believes that providing a range of options for determining capital requirements will allow banks to select an approach that is truly appropriate for their business objectives, risk appetite, structure and operating environment.

RMA also believes strongly that reform of the risk-based capital regime should be more closely aligned with enterprise risk management practices. Indeed, RMA would argue that enhancement to internal risk management practices should be integrated into the risk-based capital framework. The U.S. banking agencies have focused increasingly upon risk-based supervision over the past decade. The CAMELS rating process was amended to include a weighting for risk management strength. The risk-based capital regime itself should be so amended.

More specifically, RMA proposes that non-Basel-II U.S. banking institutions should have three tiers of risk-based capital rules from which to choose. The first tier would be generally the same as the existing risk-based capital framework. This tier would apply primarily to the least complex banking institutions. The second tier would be similar to the framework proposed in the ANPR, but with significant revisions. A simple bucketing approach may be sufficient for a number of institutions that desire a closer alignment of capital with actual risk, but have not yet developed sufficiently robust internal risk rating systems and economic capital estimation and allocation processes.

The third tier would be offered to institutions that have developed robust internal risk rating systems. Banking organizations would have to qualify under Agency standards in order to be allowed to select this approach. RMA believes that this multi-tier approach would, combined with the Basel II approach for the larger, internationally active U.S. banking institutions, will go far toward leveling the competitive playing field. Moreover, such an approach would ensure that there was a prudential level of capital in the system as a whole and that it was properly distributed across the system in relation to risk. The multi-tier approach would also help to alleviate the prospect of increasing competitive inequality that may arise among U.S. banks based upon their relative size and their election to opt in (or not to opt in) for the advanced IRB framework. Overall, it would encourage a safer and more sound banking system for the United States.

II. <u>First Tier</u>

As noted above, the first tier would permit certain banking organizations to elect to continue to use the existing risk-based capital framework for determining minimum risk-based capital requirements. This tier would generally be selected by traditional community banking organizations.

The Basel II initiative started, in part, because regulators recognized that the current risk-based capital system did not properly capture the off balance sheet risk of many global banks. However, most of the banking organizations that would select this first tier approach carry substantially all of their risk on their balance sheets, and such risk is tied to traditional bank products (*e.g.*, loans). Furthermore, the existing risk-based capital framework has worked well for such banking organizations, as demonstrated by their low insolvency rate.

By allowing banks the option to continue to use the existing risk-based capital system, the Agencies will also meet their stated goal of minimizing additional burden to banking organizations. In fact, the Agencies expressly recognized in the ANPR and recent public comments that allowing certain banking organizations to elect to continue using the existing framework may be a desirable option.

III. Second Tier

The second tier would be similar to the proposals outlined in the ANPR framework, largely a risk-characteristic bucketing approach for the assignment of regulatory capital. RMA believes that this second tier of banking organizations will have a broader array of assets than the banking organizations that will select the first tier, but rely largely on qualitative assessments of risk.

To facilitate the development of the new risk-based framework proposed within the ANPR, RMA believes that an industry-regulatory working group must be established to work jointly on the definitions and parameters of such a risk-characteristic approach. Otherwise, it will difficult to establish capital ranges reflective of the actual risk of a particular product.

IV. Third Tier

A) *Inadequacy of the ANPR Framework*

As noted above, RMA believes that the ANPR framework is inadequate for a number of U.S. banking organizations that will not be subject to Basel II but have made considerable advancements over the past decade developing internal risk rating systems and risk management frameworks. The major shortcoming of the ANPR from this standpoint is that its "one size fits all" framework neither recognizes nor promotes improvements in risk management.

The ANPR framework is strongly focused on purely external, third party information. For example, the ANPR proposes to expand the use of external credit ratings as an indicator of credit risk for externally-rated exposures. In addition, the ANPR proposes the use of loan-to-value ratios, credit assessments and other broad measures of credit risk for assigning risk weights to residential mortgages. By focusing on such external factors, the ANPR does not recognize the significant risk management systems that have been developed within many banking organizations that are smaller than the 10 to 20 largest U.S. banks.

We understand that the ANPR does include limited elements of risk management recognition. For example, the ANPR requires banking organizations that want to recognize the risk mitigation provided by a broader array of collateral types to have collateral management systems that can track collateral and readily determine the value of the collateral that the banking organization would be able to realize. However, such capital charges do not generally distinguish internal risk, and there is no variation based on a bank's internal risk rating systems. Therefore, as discussed above, the ANPR does not recognize the enhanced risk management systems currently in place at many U.S. banks. Furthermore, by not recognizing the advancement that many banks have made toward developing more robust internal risk rating systems, the ANPR could have the effect of retarding continued investment to enhance such systems.

B) *Necessity for Framework that Integrates and Promotes Risk Management*

For banks with enhanced risk management systems, an appropriate risk-based capital framework would rely on both external factors as well as a bank's internal assessment of its counterparties and exposures. Such a framework would be more risk sensitive and would provide greater incentives to banking organizations to continue to enhance their risk

management systems. Many banks have been using internal rating systems for a long time as a means of categorizing their exposures into broad, qualitatively differentiated layers of risk, as well as quantifying the credit risk associated with their exposures. Most such banks are able to provide meaningful and quantifiable estimates of one of the most fundamental drivers of credit risk, the risk of default of the obligor. However, many such banks are currently unable to provide reliable and consistent estimates of additional risk components, such as the likely loss to be incurred should a borrower default, the likely level of exposure to that borrower at the time of default, and the effect of guarantees and credit derivatives on the risk of the exposure. However, many of the institutions do have robust internal risk rating systems and could achieve substantially greater advances than are included in the ANPR. It is for this reason that an intermediate approach is appropriate to provide for increased risk sensitivity.

RMA submits that offering an intermediate approach is important in order to recognize banks' current risk management systems while also providing appropriate incentives for banks to adopt further enhancements to such risk management systems.

C) ***Risk Rating Systems***

RMA believes that, by offering such an intermediate approach, the Agencies can ensure that banks will remain focused on risk management. Establishing a capital framework which relies upon internal risk management infrastructures is entirely consistent with the thrust of regulatory and supervisory initiatives in recent years. More specifically, we note that the Agencies generally have sought to enhance banks' risk management in other contexts. For example, Federal Reserve Board Supervisory Letter 98-25 describes certain elements of internal credit rating systems that are necessary to support enhanced credit risk management and "underlines the need for supervisors and examiners, both in their onsite examinations and inspections and in their other contacts with banking organizations, to emphasize the importance of development and implementation of effective internal credit rating systems and the critical role such systems should play in the credit risk management process at sound large institutions."

In addition, Federal Reserve Board Supervisory Letter 99-18 "directs supervisors and examiners to evaluate internal capital management processes to judge whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of the institution's capital needs" and "describes the fundamental elements of a sound internal capital adequacy analysis – identifying and measuring all material risk, relating capital to the level of risk, stating explicit capital adequacy goals with respect to risk, and assessing conformity to the institution's stated objectives – as well as the key areas of risk to be encompassed by such analysis." Federal Reserve Board Supervisory Letter 99-18 also noted that "supervisors have placed increasing emphasis on banking organizations' internal processes for assessing risks and for ensuring that capital, liquidity, and other financial resources are adequate in relation to the organizations' overall risk profiles."

Furthermore, remarks by Federal Reserve Board Governor Olson on September 16, 2005 highlighted the risk of nontraditional mortgages, and noted that "banks' risk management procedures must take into account the unique characteristics and credit risk profile of these novel types of loans." Governor Olson also mentioned that in response to certain other credit- and interest-rate risk management issues, that the "Federal Reserve and other regulators have, of course, concentrated on evaluating banks' risk management capability." Accordingly, many U.S. banks are already required by the Agencies to have enhanced risk management systems.

Despite advances in risk management made by many U.S. banking organizations, we recognize that the Agencies would require banking organizations electing this third tier approach to meet certain minimum qualifications, and we are prepared to make suggestions in that regard at an appropriate time. Furthermore, RMA acknowledges that implementation of any new capital framework such as this third tier approach may require a transition period.

V. Other Risks

RMA believes that it is appropriate that the focus of all three tiers should be on credit risk. However, RMA notes that non-credit risk – and in particular operational risk – is of rising importance in banking institutions of all sizes and types, as the pace of change, the use of technology, complexity, outsourcing and competition all increase. Rather than impose a capital charge on all institutions based on an explicit calculation of the level of this risk – something that is most unlikely to be cost-effective – the accompanying supervisory regime should emphasize the importance of a strong framework and sound practices for managing such risk. This emphasis will help ensure that inherent risk of these kinds is managed down and that there is enough capital in individual institutions and in the system as a whole for all of the resultant residual risk.

VI. Conclusion

RMA submits that the multi-tier approach described in this comment letter is necessary in order to recognize the complexity of the U.S. banking system. By developing a multi-tier approach, the Agencies would be able to permit those banking organizations that wish to use a simple system to do so, while also allowing larger, more complex banking organizations to obtain the benefit of their enhanced risk management systems.

In testimony before the U.S. Senate Banking, Housing and Urban Affairs Committee on November 10, 2005, Comptroller of the Currency John C. Dugan stated, "we are committed to improving risk sensitivity of the risk-based capital rules for all institutions, but doing so in a way that is tailored to the size, structure, complexity, and risk profile of the institution, and that ensures safety and soundness." RMA believes strongly that a multi-tier approach is the only viable means to accomplish this all important goal. Furthermore, the approach detailed herein would allow capital to be one part of an integrated risk management system, rather than a stand-alone criteria.

Response of the RMA Capital Working Group[1] to the Advanced Notice for Proposed Rulemaking to the U.S. Risk-Based Capital Rules

I. Introduction.

This paper represents the response of the RMA Capital Working Group to the Advanced Notice of Proposed Rulemaking ("ANPR") regarding U.S. bank capital regulations, as issued in the Federal Register on October 20, 2005. The large majority of the Capital Working Group consists of regulated banks that will be mandatory or opt-in institutions subject to Basel II's AIRB approach. This response concentrates mainly on the points of view of these Basel II institutions.

RMA has been a strong advocate of the capital reform process embodied within Basel II and fully supports further reform of the risk-based capital guidelines to enhance risk sensitivity for all U.S. institutions. We believe that such reform must establish a multi-tier framework to enable the continued evolution of risk management practices within the industry. Further, we recommend establishing an industry-regulatory agency working group to ensure that the risk-based capital guidelines promote and enhance risk sensitivity.

The ANPR has only a limited direct effect on Basel II banks, associated with the possible use of it as a floor for the Basel II capital levels during the transition years. Going beyond this "floor" issue, about which we have *much* concern and discuss in detail below, the proposed capital regulations for the non-AIRB banks should be based on the best risk measurement practices, in such a way as to minimize potential resource allocation problems. For this reason, we provide a discussion of the broad issues that we believe must be addressed in crafting more risk sensitive capital guidelines for non-AIRB banks. Individual member banks of our group may be providing more specific comment on the details of the ANPR, such as suggestions for risk-bucketing.

II. The objectives of revising the minimum capital standards for all U.S. banks.

While we agree generally with the basic principles expressed in Part II of the ANPR, we believe additional objectives should be added as follows:

- Make the new standard(s) more risk-sensitive in order to improve the ability of regulators to meet their own prudential objectives such as establishing a real minimum soundness level, protecting the deposit insurance fund, etc.
- Make the new standard(s) more closely aligned to best-practice estimates of credit and other risks. Meeting this objective is critical to reducing or eliminating instances in which the current standard results in inappropriate resource-allocation or competitive effects.
- Provide incentives for all banks to migrate toward better, albeit more complex, risk measurement processes and associated regulatory capital standards.
- Provide for no further delay in implementing the Basel II AIRB approach. At the same time, regulators should move at all deliberate speed, on a similar timetable, to implement the other, non-AIRB form(s) of capital regulation. As shall be discussed

[1] The Capital Working Group of RMA consists of senior risk management officers at large banking organizations responsible for the measurement of risk and the determination of Economic Capital. The names of the institutions represented on the Capital Working Group, along with staff members contributing to the preparation of this response, are shown at the end of the paper. Individual banking organizations that are members of the Group may be responding separately to the ANPR, and may hold opinions regarding the proposed revisions to the risk-based capital guidelines that differ from those expressed in this paper.

below, we believe that no fewer than 3 tiers of capital regulation are needed in order not to disadvantage one or more classes of banks in the U.S.

III. Background: Risk-Based Capital Guidelines should be more risk sensitive for all U.S. institutions. In the less than two decades since the Basel Capital Accord was formulated, there have been very significant changes in the risk measurement, risk management, and risk pricing arenas. Critically, new, formal *risk metrics* (including Economic Capital) are used within calculations of risk-adjusted-rates of return, and are generally made without regard to regulatory minimum capital standards. But for a number of individual credit products, ranging from certain mortgage products, to other retail products, to highly-rated commercial credits, the existing Accord has become a too-high-standard. Indeed, any activity for which the best-practice risk metric (Economic Capital) generates a low internal capital allocation (below 8%) entails a regulatory capital standard that may affect business line decisions. In the worst case, the bank either has to find a way to get around the too-high capital standard or must charge higher rates on loans to which the high capital is allocated. In such cases, the effect of the too-high capital standard could cause all regulated banks to give up market share to non-regulated financial institutions or foreign banks.

There are, of course, cases in which, for a particular credit product, the current Accord requirement is too low – entailing an implied level of minimum soundness for a bank that, if the bank held such assets and held only 8% capital against those assets, the bank would be rated below, say, investment grade by the rating agencies. However, when capital regulations err on the side of being too low, the public still is protected by the built-in desires of shareholders of publicly-held banks not to allow their public credit ratings to decline to too low a level. The banks are required by the market to hold more capital for the risky product than the regulatory minimum. But when the capital regulations err on the side of being too high, as indicated above, resource misallocation may result – and this may negatively affect all regulated banks in the U.S.[2]

Improvements in risk-measurements are often viewed by financial markets as tantamount to reductions in risk. For example, one can view more accurate risk measurement as involving less "model error." Put another way, if we could all agree that, with the most sophisticated risk measurement, a particular portfolio should have capital of X, then, when using an unsophisticated process for measuring risk, the same portfolio should have more capital allocated to it because of the uncertainties surrounding the less accurate risk measurement process. While the new risk metric technologies have more closely aligned internal economic capital to risk, they are neither perfect nor available to all institutions. The metrics' presence mainly at larger institutions is due, in part, to the role of these large banks (and their unregulated competitors) as price-setters. However, large size, by itself, does not guarantee lower risk.

Below we discuss the need for having at least 3 "tiers" of capital regulation in the U.S. As the bank qualifies for the next higher level of risk sophistication and risk measurement accuracy, the minimum capital standard should decline, as a generality, for the reasons above. In individual cases, of course, the bank may nevertheless have chosen to assume high risk in connection with its improved risk measurement and, in such a case, the minimum capital requirement under the more sophisticated regulatory standard will be higher than

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[2] A minimum capital requirement can be binding even when it is *below* the economic capital requirement for the loan, because the bank may factor in the cost of violating regulatory capital minimums in some future tail event. That is, markets may require the bank to hold an even higher level of capital than otherwise, when, because of the "closeness" of the regulatory minimum to the desired level of capital, there is too high of a chance of incurring the costs of being declared undercapitalized by supervisors. See William Lang, Loretta Mester, and Todd Vermilyea, "Potential Competitive Effects on U.S. Bank Credit Card Lending from the Proposed Bifurcated Application of Basel II," Federal Reserve Bank of Philadelphia, working paper, December 5, 2005, pp. 13-15.

under the existing standard. In all cases, moreover, the examination process should uncover instances in which the new regulatory standard is being applied in inappropriate fashion.

With regard to Basel II AIRB banks, the current safeguards – the risk-based floors for the 3 transition years, the minimum leverage floor, and the supervision process itself – should act to assure that all AIRB banks will have more than adequate capital under Basel II.

IV. Recommendations for changes in the capital structure for non-AIRB banks.

A. Non-AIRB banks should be allowed to continue with the current, or an only-slightly-revised, capital standard rather than have to incur the expense of more complex data management systems. For the vast majority of community banks, the existing Accord is not binding. These institutions wish to hold and do hold very much more capital than the current regulatory minimum. Further, many of these institutions do not have shares that are publicly traded or debt that is rated by bond rating agencies. To some extent, the higher capital levels of these institutions are a reaction to the lack of market discipline on the actions of management. In addition, these institutions often have very significant market shares in the communities that they serve, allowing the bank to enjoy lower deposit costs and possibly higher yields on assets. Because of these conditions, and the very high capital levels of these institutions, changing the current standard, except in a very limited manner, is not necessary. Moreover, it might be prohibitively expensive for these institutions to be forced to move to a new Accord that is significantly changed from the current Accord, especially a new set of capital rules that is based on bucketing procedures for which the necessary data cannot be found in the General Ledger. In short, the expense of a significant change for these institutions is not justified by any significant benefits, to either the banks involved or to the regulatory agencies. At the least, all non-AIRB banks should be given the option of staying with the existing Accord. In particular, the vast majority of U.S. banks should be allowed to continue, if they wish, with a "product-based" risk segmentation, rather than any new standard that depends on expensive segmentation of each credit product into risk-characteristics such as LTVs, FICO, etc. As with the current Accord, supervisory examinations will uncover instances in which the bank's capital levels, although higher than the minimums, are too low for its particular risks.

B. Larger institutions should be given the option of moving toward a more complex regulatory capital structure that is based of internal risk rating systems or is risk-characteristic-based. We would expect that, eventually, banks of all sizes will invest significantly to make the transition to best-practice Economic Capital (EC) systems, because such systems can help improve risk-adjusted returns to shareholders. However, even large (but not the very largest) institutions have often just begun the process and will not be ready to attempt the transition to a fully-internalized use of EC and Basel II for several more years. In the meantime, the current framework is out of date and may constitute for many such banks a cumbersome burden (from a business perspective) as well as an inaccurate measurement of soundness (from the point of view of best-practice prudential regulation). Some of these banks may be price-setters in specific geographic or product markets. Therefore, for these institutions, it is vitally important to reduce the number of instances in which the current Accord results in too-high capital allocations for specific low-risk products. This can only be done by movement toward a truly risk-sensitive approach. For this reason, and for the reason that the vast majority of banks do not need to or cannot afford to move to a more risk-sensitive approach, we conclude there must be at least 3 "tiers" of capital regulation in the U.S., in addition to the framework that AIRB Basel II institutions must adopt.

There are basically two possible approaches toward such an increase in risk sensitivity for banks desiring a regulatory capital system with increased risk sensitivity:

- a risk-characteristic-based "bucketing" approach as is described in the ANPR, or
- an internal ratings systems approach based on internal bank estimates of PDs.

We discuss the pros and cons of these two approaches below.

1. The use of risk-characteristic-bucketing approach for determination of capital allocations. There are a number of attractive features of the risk-bucket approach proposal in the ANPR:

a) The risk-bucket approach would be significantly more risk sensitive than the old Accord.

b) The risk-bucket approach would not require corroborating quantitative expertise to support more appropriate risk-weighting. Low-risk assets merit lower risk-weights even if they are housed in smaller institutions that lack the data or analytical expertise to support compliant estimates of PD and other IRB parameters. While there is some cost in gathering and maintaining information that would conform to a regulatory risk-characteristic grid, many institutions will find this approach far more accessible that one that requires detailed empirical exercises.

c) The risk-bucket approach would minimize the burden faced by regulators relative to the Basel II IRB approaches. With rigid, pre-defined grids mapping risk-characteristics to risk-weights, regulators would not need to verify the quality of internal segmentation schemes and PD estimates for the hundreds or thousands of banks that might choose to migrate to a more risk-sensitive risk-weighting regime.

d) The risk-bucket approach would minimize or eliminate the disparity in risk-weighting across institutions. Assets with identical risk-characteristics would receive identical risk-weights that are independent of institution-specific analytical exercises.

There are, of course, some pitfalls to the above approach, in addition to our worry over the cost of such an approach for smaller banks.[3]

a) First, it will be difficult to reach consensus on the definitions of each risk-characteristic variable and the ranges of values for each variable. For example, "LTV" can be the LTV at origination or an LTV that is updated via some device such as the use of housing price indices. Similarly, "FICO" can be FICO at origination, or the more risk-appropriate updated FICO. Questions about how, and how often, each such variable should be updated will arise. Then, there is the question of how to set ranges for each variable. The minimum number of buckets when using two risk variables is four. Yet, significant improvements in risk-sensitivity can be achieved by having a greater number of ranges for each risk variable. If there are, say, 4 ranges for FICO scores (<600, 600-660, 660-720, and >720), and 4 ranges for LTV (say, <60%, 60-80%, 80-90%, and >90%), and 3 types of delinquency status (current, 30DPD, and 60+DPD), the total number of buckets for the product is 48. Is it workable to have that many buckets for each type of credit product? Conversely, are fewer buckets worth the effort?

b) There is currently a wide diversity in internal practice for banks using bucketing schemes for estimating the risk parameters for Economic Capital. Therefore, no matter the final decisions on definitions of bucket variables and their ranges, the resulting capital standard will have bucket descriptions that differ from those in current use by virtually all banks that use such segmentation processes. As a result, the cost of regulatory compliance will be significant. This cost could be reduced by formation of an industry-regulatory group

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[3] While we appreciate this concern over "diversity", we note that it is quite appropriate to have significant diversity in, say, PD and LGD estimation, because the actual outcome of a loan will depend on the origination process, the loan monitoring process, and the workout process (i.e., what is done after technical default) – all of which differ significantly across AIRB banks. For this reason, we do not subscribe to the view that diversity is a problem in the AIRB approach or would be a problem in any other regulatory capital standard. Additionally, we wish to point out that none of the regulatory schemes being considered permit recognition of the fact that two banks, about to acquire the same asset, would properly assign different marginal capital allocations to the same asset, because of significant differences in the size and diversification of the portfolios into which the new asset would be placed. This is still another reason why significant diversity in economic capital allocation should be embraced, not avoided.

process in deciding on the definitions of risk-characteristics and the choice of ranges for each characteristic.

c) It is vitally important that the industry and its regulators "get it right" with respect to setting the capital risk weights for each bucket. In order to minimize the instances in which the bucket risk-weights are either significantly too high or significantly too low, the determination of the bucket risk-weights should properly take many months, possibly years, of consultation between practitioners and regulatory agencies, as was the case in devising the international Basel II standard.

2. The Internal Ratings Based approach. As an alternative to the approach outlined in the ANPR, an internal ratings based approach which uses an institution's PD estimation would be more risk sensitive. Furthermore, the regulatory agencies would set downturn LGDs and EADs – critical inputs into the determination of economic capital. Because these LGD and EAD parameters have already been discussed in the context of the international Basel II, the time required to implement a PD-based approach should be less than the time needed for a properly specified bucketing approach.

3. For the institutions that may be subject to a revised capital framework, there should be an operational risk or "other risk" charge, in addition to credit risk capital charges. This "other risk" charge could be modeled after the Basel II Standardized op risk charge, which can be inexpensively calculated.

4. Like Basel II banks, banks under the revised capital standard should be subject to appropriate examinations of internal methods for identifying and holding capital against all its risks. These examinations should be patterned after, but should be less complex than, the so-called "99-18" examinations of large, complex banking organizations ("LCBOs").

V. The "Floor" for Basel II AIRB. There are several reasons why the floor for AIRB capital should not be based on the framework outlined in the ANPR.

- Regulatory burden. AIRB banks would effectively have to make 4 separate capital calculations each quarter – the existing Accord, the new standard outlined in the ANPR, the new AIRB approach, and, of course, best-practice internal Economic Capital. Moreover, to the extent the new ANPR is formulated in terms of risk-characteristic-based buckets, the AIRB bank would have to pay for maintaining a second set of buckets – buckets that would likely be expressed in terms of a very significantly changed set of Call Report forms. These buckets surely will differ from the segmentation process used internally to estimate the risk parameters for the AIRB approach. This cost would be quite significant for the largest, internationally-active AIRB banks, especially in circumstances where a credit product, delivered in a foreign country, does not lend itself to a bucket approach (e.g., FICO scores are not available in many foreign countries).
- A higher floor. If policymakers do not mirror best practice economic capital estimation practices in choosing the risk-weights for the new buckets as outlined in the ANR, there is the chance that the new standard will involve higher capital than the current Accord – thereby effectively raising the floor for the AIRB banks.
- The ANPR risk-weights may become a de facto supervisory standard for the AIRB banks' estimates of risk parameters. The international Basel II process has gone to great lengths to allow Basel II AIRB banks freedom in how they define, for internal purposes, the segmentation of corporate and retail loan portfolios. Corporate portfolios are expected to be segmented by obligor ratings and facility ratings (PDs and LGDs), while retail portfolios are expected to be segmented by risk characteristics such as LTVs, delinquency status, FICO score, etc. -- except in instances where the bank can show that a series of loan-level PD and LGD estimating functions provide for an even greater degree of statistically-proven segmentation. Once AIRB banks have to compute the ANPR bucket-based capital requirements for "floor" purposes, supervisors might ask AIRB banks to justify why their own segmentation differs from

the ANPR approach and why their estimated PDs for each bucket differ from the regulatory agencies' assumed PDs in setting the buckets' risk-weights.[4]

VI. Conclusion.

We believe that the important objectives of prudential regulation would be most easily reached by a 3-tiered standard for risk based capital guidelines. Importantly, all non-mandatory-AIRB banks would be given the option of choosing this new capital standard without being required to migrate to either of the other two tiers. Additionally, there are a number of community banks that will choose to remain on the current Accord and these institutions should be allowed to do so. Of course, some LCBOs should be mandatory Basel II Advanced IRB banks, because of the importance of these large institutions within the U.S. and world economies.

We view this *optionality* as vitally important. It is also critical that, in assigning capital to any defined bucket under either of the first two tiers, the regulatory agencies follow how economic capital is calculated for such buckets by best-practice banks. These capital allocations should be based on the only known method for rigorously estimating risk and assigning capital – the underlying Economic Capital methodologies. We remain confident that the U.S. regulatory agencies will apply best practice economic capital estimation principles to *all* tiers of bank capital regulation, not just within the Basel II AIRB approach. Toward this end, we are ready, willing, and able to work with the agencies in measuring risk levels and providing research support for particular risk-weights, for any buckets defined under either of the two (or more) non-AIRB capital tiers.

Institutions in the RMA Capital Working Group:

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Capital One
Comerica
HSBC/North American Holdings
KeyCorp
PNC Financial Services Group
State Street
Union Bank of California
Wachovia
Wells Fargo
Bank of America
Citigroup
Countrywide
JPMorganChase
MBNA
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HSBC/North America Holdings: John Zeller, Executive Vice President, Credit Risk Management; David Coleman, Senior Vice President, Credit Risk Management; David Morin, Senior Vice President, Credit Risk Management; John Roesgen, Senior Vice President, Finance; Stephen Mongulla, Director, Credit Policy

[4] We are not opposed to supervisors developing a series of soundly researched loan buckets in which nationwide data are used to estimate Economic Capital allocations for each bucket. Such a tool would be useful for benchmarking purposes, but only if the development of the tool were the result of a lengthy consultation process between supervisors and banks experienced in the use of Economic Capital processes.

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