E*TRADE BANK
Member FDIC

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552
Attn: # 2005-40

Ms. Jennifer J. Johnson
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Docket # R-1238

Office of the Comptroller
Public Information Room
Mail Stop 1-5
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Washington, D.C. 20219
Attn: Docket number 05-16

Robert E. Feldman
Executive Secretary
Feral Deposit Insurance Corp.
550 17th Street, N.W.
Washington, DC 20429
Attn: Comments/Legal ESS RIN 3064-AC-96

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

Dear Sir or Madam:

E*TRADE Bank, Arlington, Virginia (the "Bank") appreciates the opportunity to comment on the joint Advanced Notice of Proposed Rulemaking (ANPR) published on October 20, 2005.[1] The joint ANPR was issued for the purpose of suggesting changes in the Basel I capital framework to make that framework more risk sensitive, and to ameliorate potential competitive disparities that might arise when the Basel II framework is implemented. We believe that the joint ANPR makes many useful suggestions in furtherance of those goals, and we applaud your efforts to improve the current Basel I capital framework for those institutions not subject to Basel II.

There is one modification, however, that we believe would significantly enhance the proposal and would further the goal of making the modified Basel I standard better

[1] 70 Federal Register 61068 (October 20, 2005).

correlated to credit risks. The modification would also address the anomaly that is created both under the current Basel I and the proposed Basel I-A standard: a general failure to recognize that loans supported by any bona fide collateral have less credit risk than unsecured loans made to the same counter-party. Thus, the current capital standards place loans secured by one to four family residential homes in a 50 percent risk weight basket, and loans backed by OECD government obligations, such as Mexican bonds, in either the 0 or 20 percent risk basket. However, extensions of credit collateralized by other assets, such as debt or equity securities, are subject to the same capital charge as unsecured loans.

The joint ANPR acknowledges that the capital rules should take into account the risk mitigation provided by a broader array of collateral, and that such an approach would make the capital standards more risk sensitive and provide additional incentives to utilize risk mitigation techniques. The proposal states that the banking agencies are considering expanding the list of recognized collateral to externally rated debt and mortgage-backed securities.

We believe that consideration should also be given to recognizing margin loans that are secured by unrated debt or listed equity securities that are subject to prudent margin maintenance and other requirements under applicable rules and regulations or provide similar protections through contractual provisions.

A margin loan is an extension of credit made to finance the acquisition of certain securities. Under the Federal Reserve Board's Regulation T[2] a marginable security is primarily limited to securities trading on a national exchange, securities trading on the NASDAQ Stock Market, non-equity securities, securities issued by registered mutual funds and certain readily marketable foreign equity securities. Under the Board's Regulations T and U,[3] the initial extension of credit to purchase margin securities is generally limited to 50 percent of the market value of the securities. In other words, at the time of the initial extension of credit, the value of the collateral must equal or exceed 200 percent of the amount of the loan.

In addition to limitations described above, the rules of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) impose maintenance margin requirements.[4] Under these requirements the market value of the collateral supporting a margin loan generally cannot go below 133-1/3 percent of the amount of the loan still outstanding (i.e., the equity in a customer's account must be equal to or greater than 25 percent of the cash and market value of the securities in the account). The lender may impose a higher margin maintenance requirement under the loan agreement, and many broker-dealers in fact do so. E*TRADE Securities LLC, for

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[2] 12 C.F.R. part 220. Part T applies to broker-dealers.

[3] 12 C.F.R. part 221. Part U applies to banks and lenders other than broker-dealers.

[4] NYSE Rule 431 and NASD Rule 2520.

example, imposes a "house" 30 percent maintenance requirement. If the value of the securities falls below the margin maintenance requirement, the lender can place a "margin call," which will require the immediate deposit of cash or securities to restore the margin level to the required percentage, or the lender can sell the securities without contacting the borrower.[5]

The experience of the Bank's broker-dealer affiliates, and we understand the industry norm, is that margin lending, as described above, exposes the lender to little, if any credit risk. We find that credit losses on such loans typically run at the 10 basis point level. This compares with the 15 basis point average charge off rate for prudentially underwritten residential real estate loans.[6]

The protection afforded by collateral subject to the margin requirements has already been recognized by the Federal banking agencies in connection with the capital charge imposed on exposures to securities firms. As amended effective July 1, 2002, the bank capital rules provide that certain claims on SEC registered broker-dealers are assigned to the 20 percent risk weight basket provided the broker-dealer has one of the three highest investment grade ratings, or that the transaction is protected by a debt or equity securities subject to a margin agreement.[7] The terms of the margin agreement must provide that:

(1) The debt or equity securities constituting the collateral must be liquid and readily marketable;

(2) The claim and the collateral must be marked-to-market daily; and

(3) The claim must be subject to daily margin maintenance requirements under standard industry documentation.

The agencies' stated that they were applying a 20 percent risk weight to these exposures because they "generally pose relatively low credit risk to banking organizations."[8] In essence, the agencies are equating exposures supported by margin agreements with claims on entities that have one of the three highest investment grade ratings. The joint ANPR suggests that exposures that are collateralized by investment grade securities should be assigned to either the 20 percent (for the top two long-term grades) or 35 percent basket (for the third highest grade). Therefore, it would be entirely consistent with the joint ANPR to assign loans supported by margin agreements to one of

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[5] NASD, "Investing With Borrowed Funds, No Margin for Error" (September 11, 2003).

[6] Board of Governors of the Federal Reserve System, "Charge-Off and Delinquency Rates, Not Seasonally Adjusted." (Dec. 2005). See also, Fitch Ratings, Special Report: "U.S. Residential Mortgage Products, Only Time Will Tell." (September 22, 2005).

[7] 67 Fed. Reg. 16971 (April 9, 2002).

[8] Id at 16975.

these baskets. However, in light of the over-collateralized position of margin lenders, and the treatment margin loans receive under the Basel II Accord (described below), we believe that the 20 percent risk basket would be more appropriate.

In addition, it should be noted that the 2002 regulation requires that the contract from which the claim arises can be liquidated, terminated, or accelerated immediately in bankruptcy or similar proceedings, and the security or collateral agreement will not be stayed or avoided under the applicable law of the relevant jurisdiction. Under the U.S. Bankruptcy Code, the right of a stockbroker or financial institution to cause the liquidation, termination, or acceleration of a securities contract is not to be stayed, avoided, or otherwise limited.[9] The term "securities contract" is defined to include a contract for the purchase, sale, loan of a security, mortgage loan, and "any margin loan."[10] Thus, this requirement is met as well.

Furthermore, additional protection against bankruptcy is afforded by the retail nature of the margin lending business. When a financial institution is engaging in large dollar transactions with a single or very few counter-parties, the risks posed by a bankruptcy of one of these counter-parties looms large. However, the potential risk of a bankruptcy filing is much less a concern when considering retail transactions in which the bank is making relatively small extensions of credit to thousands of diverse customers. In this case, the risks posed by bankruptcy are greatly reduced, and in light of the over-collateralized position of the bank, negligible.

A recent study by the staff of the Federal Reserve Board has also acknowledged the dramatic reduction in credit risk that results from margin agreements.[11] This study focused on the effects of margin agreements to reduce credit risk in the Over-The-Counter (OTC) derivatives market. It concluded "a margin agreement with standard terms can reduce counterparty credit exposure by over 80 percent."[12]

The Basel Committee has also recognized the credit protection afforded by margin agreements. Under Basel II a bank receives capital relief for loans and other exposures secured by eligible financial collateral, defined to include both debt and equity securities.[13] The Basel II "standardized approach" also provides that banking organizations may effectively reduce their exposure by the adjusted value of the

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[9] 11 U.S.C. § 555.

[10] 11 U.S.C. § 741.

[11] Michael Gibson, "Measuring Counterparty Credit Exposure to a Margined Counterparty," Finance and Economics Discussion Series, Divisions of Research and Statistics and Monetary Affairs, Board of Governors of the Federal Reserve System (September 2005).

[12] Id. at 3.

[13] Basel Committee on Banking Supervision, "International Convergence of Capital Measurement and Capital Standards," pars. 119 & 145 (November 2005)(hereinafter "Basel II Accord").

collateral.[14] In addition, various conditions must be met regarding such matters as the legal enforceability of the security agreement, the bank's procedures for the timely liquidation of collateral, and the liquidity of the collateral.[15]

The adjusted value of the collateral is determined by "haircutting" the market value by a percentage that is either provided by the Accord, or alternatively computed by the bank using its estimates of market price volatility.[16] Another adjustment is required if the value of the exposure is also subject to fluctuation, or where there is a maturity mismatch. However, for a simple margin loan collateralized by unrated debt and main index (listed) equity securities, the "haircut" prescribed by the Accord is 15 percent.[17] Thus, using this approach, the value of the securities collateralizing a margin loan would be reduced by 85 percent of the value of the collateral, assuming no adjustment is made for changes in the amount of the loan exposure and no maturity mismatch. This equates to a 15 percent risk basket for fully collateralized margin loans, and an even lower risk basket to the extent the margin loan is over-collateralized. If a bank chooses to use its own data for computing the "haircut," even greater capital relief may result.[18]

This treatment not only demonstrates the low credit risk associated with margin loans, but also highlights the competitive disadvantages that non-Basel II institutions will face when competing with banking institutions subject to Basel II. An important goal of the joint ANPR, to mitigate the competitive effects of a bifurcated capital system, will thus be advanced if provisions are included to recognize the very low credit risk characteristics of margin loans.

In conclusion, we are requesting that the banking agencies enhance the proposed Basel I-A standard by assigning margin loans, secured by debt and listed equity securities, to a risk basket that more appropriately reflects the credit risk of these products. In this regard, we suggest that the 20 percent risk basket would be most appropriate, especially in light of the very favorable treatment these loans will receive under the Basel II framework, whether under the standardized approach or the more advanced approaches. This proposal will further the goals of the proposed Basel I-A by making it more risk sensitive and by helping to ameliorate potential competitive advantages that Basel II institutions will have due to the lower capital costs to them of offering this product.

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[14] Basel II Accord ¶ 121.

[15] Basel II Accord ¶¶ 117, 122-126.

[16] Basel II Accord ¶ 133.

[17] Basel II Accord ¶¶ 145-153.

[18] One foreign bank regulator has opined that under the Basel II standardized approach described above, the capital charge for margin loans will "likely reduce to zero." Australian Prudential Regulation Authority, Discussion Paper: " Implementation of the Basel II Capital Framework, Standardized Approach to Credit Risk." at page 4 (April 2005).

Thank you for considering our comments. If you have any questions, please contact me at (703) 236-8032.

Sincerely yours,

/s/ JOHN A. BUCHMAN

John A. Buchman
General Counsel
E*TRADE Bank