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KeyCorp's Response to the U.S. Banking Agencies' Notice of Proposed Rulemaking Regarding the Implementation of the New Basel Accord in the U.S.

Introduction

KeyCorp appreciates the opportunity to comment on the U.S. Banking Agencies' Notice of Proposed Rulemaking (dated September 25, 2006), which concerns the implementation of Basel II in the United States.

KeyCorp has actively participated with industry groups such as RMA in constructing their response to the agencies' ANPR as well as NPR. We are honored to have had the opportunity to work with them, as well as with all other participating financial institutions. In addition, as an individual institution, we have discussed and analyzed the NPR questions, particularly in regards to the implementation questions and the operational risk questions.

In general, we support the agencies' effort to move towards a more risk sensitive regulatory capital regime. However, the new regulation should not put too much regulatory burden on banks, so that more banks are willing to opt-in.

Listed below are our specific responses pertaining to certain questions, followed by additional comment and request for clarification.

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Response to NPR Questions

Questions: 3, 5, 6, 7, 8A, 8B, 9, 10, 11, 12, 19(ii), 20, 21, 27, 28, 61

The BCBS calibrated the proposed 0.6 percent limit on inclusion of excess reserves in tier 2 capital to be approximately as restrictive as the existing cap on the inclusion of ALLL under the general risk-based capital rules, based on data obtained in the BCBS's Third Quantitative Impact Study (QIS-3).

Question 3: *The agencies seek comment and supporting data on the appropriateness of this limit.*

The limit based on a percentage of RWA for Credit is appropriate because the source of the issue arises for loan loss reserves only. The issue, therefore, is about what the right percentage is, if at all there should be a limit to how much can be counted for Tier 2 capital.

In pure theory, reserves are to be built up during the periods of low losses and depleted during periods of high losses. In practice banks often preserve or build reserves in times of high losses. Therefore, most banks have reserves in excess of EL during all parts of the cycle; some others do not. On average over the cycle, the net positive value of excess reserves is directly the result of banks following the practice mentioned above instead of theory. Why do banks do that? To signal and address safety and soundness concerns, to the satisfaction of regulators as well as investors. It is only fair that the full extent of excess reserves be allowed to be counted towards Tier 2 capital since it is, after all, the result of attempts to ensure safety and soundness. A limit will be unfair to banks that take a conservative and dogged view of not reducing reserves in bad times, thus enhancing its safety and soundness at the cost of its shareholders.

0.6% of Credit RWA is not a small number. For most banks, the net positive value of excess reserves on average over the cycle is not going to far exceed this number. By allowing deduction to Tier 2 capital without limit, Basel II is not going to significantly alter (lower) the amount of subordinate debt (and similar support for senior debt-holders) issued by banks.

The existing cap on the amount of ALLL that can be counted as Tier 2 capital is arbitrary and does not have a sound economic basis. Trying to match that arbitrary figure by another means leads to an equally arbitrary limit.



The agencies are, in short, identifying a numerical benchmark for evaluating and responding to capital outcomes during the parallel run and transitional floor periods that do not comport with the overall capital objectives outlined in the ANPR. At the end of the transitional floor periods, the agencies would re-evaluate the consistency of the framework, as (possibly) revised during the transitional floor periods, with the capital goals outlined in the ANPR and with the maintenance of broad competitive parity between banks adopting the framework and other banks, and would be prepared to make further changes to the framework if warranted.

Question 5: *The agencies seek comment on this approach to ensuring that overall capital objectives are achieved.*

In order to re-evaluate the consistency of the framework and (possibly) revise it during the transitional floor periods, the criteria to judge whether overall capital objectives have been achieved are numerous, of which the following are the most important:

- a. Capital should be adequately risk sensitive
- b. Distinguish risk (parameters) amongst all significant portfolios and consequently distinguish the capital they attract.
- c. A simple rank-ordering of capital numbers in the framework, according to each of several different criteria, should correspond to ex-ante (at the time of setting the criteria without reference to capital numbers that fall out) intuition and common sense.
- d. A correspondence (not equality) between capital for on balance-sheet and capital for off-balance-sheet (securitization). That is, little or no regulatory arbitrage opportunities.
- e. (less important than the ones above) The capital for the banking industry as a whole approximates the current leverage ratio calculations (8% of assets).

Competitive considerations, both internationally and domestically, will be monitored and discussed by the agencies on an ongoing basis. With regard to implementation timing concerns, the agencies believe that the transitional arrangements described in section III.A. of this preamble below provide a prudent and reasonable framework for moving to the advanced approaches. Where international implementation differences affect an individual bank, the agencies expect to work with the bank and appropriate national supervisory authorities for the bank to ensure that implementation proceeds as smoothly as possible.

Question 6: *The agencies seek comment on all potential competitive aspects of this proposal and on any specific aspects of the proposal that might raise competitive concerns for any bank or group of banks.*

Under Pillar 2 of Basel II, it is no doubt the prerogative of the regulators exercising local jurisdiction to incorporate prudence and judgment around Pillar 1 as well as the process of qualification. No one is questioning that ultimate authority. However, the more the



Pillar 2 requirement in one country differs from another in fundamental ways, the more international competitive considerations (advantages/disadvantages) emerge as a natural rule. This vitiates one of the basic principles set forth at the beginning of Basel II talks – create a level playing field in cross-border banking. For example, the more the US NPR or the CAD deviates from BCBS Basel II, the more competitive issues will emerge and persist to the detriment of one group of banks, which is definitely not in the interest of the international banking community as a whole.

In addition, restricting to Pillar 1 (capital formulae), differences have arisen that may lead to international competitive advantages to some and disadvantages to others. An example (in the formulae below $F[\bullet, \bullet]$ represents a function) in point is:

$$\text{Basel II: Capital Factor} = LGD * F[PD, AVC] - LGD * PD$$

$$\text{US NPR: Capital Factor} = LGD * F[PD, AVC] - ELGD * PD$$

Whether LGD is computed from historical data or from the default formula in the NPR, LGD will be greater than ELGD. Thus, in a systematic way, a smaller number is being subtracted in the US NPR formula in comparison with the Basel II formula. The difference may not be significant (in so far as capital factor is concerned) for some ranges of PD and ELGD but it is significant for some other ranges of PD and ELGD.

Of course, international competitive considerations apply by and large to internationally active banks only. Domestic competitive considerations stem from a different source – between those that will be under Basel II and those that will not be. At first glance, it might appear that US domestic competitive considerations are much more of a concern for the NPR than international competitive issues. But we will argue otherwise in the subparagraphs below.

- a. For almost a hundred years, the competitive spectrum between large banks (ones likely to be in Basel II Advanced) and small community banks (ones not likely to be in Basel II Advanced) has been as follows: large banks have had the competitive advantage of the ability to structure new products and use economies of scale in systems; small banks, on the other hand, have had the competitive advantage of strong relationship with their customers. These real competitive advantages of each group are not going to change with capital adequacy rules.
- b. Most large banks already price their products using economic capital – Basel II advanced method only brings regulatory capital requirements closer to economic capital. The alignment of regulatory capital to economic capital (whether there is reduction in regulatory capital or not) is not likely to affect their pricing. Consequently, smaller banks are not going to face unfair pricing competition.



- c. For several years now, most small banks have held in their books significantly larger (costly) capital than the current general risk-based capital rules – particularly in comparison with larger banks. Therefore, capital (not what the rules, current or revised, say but what is held in the books – because it is the latter which incur the cost) has not been a competitive issue between large (ones likely to be in Basel II Advanced) and small community banks (ones not likely to be in Basel II Advanced).
- d. That leaves the question of whether larger banks may see a large reduction in capital with the implementation of Basel II and use that capital to buy smaller banks. Studies have shown that very few mergers and acquisitions (whether in banking or in general) add shareholder value. Merger and acquisition activities in the banking sector will continue eroding value as a result of agency costs, irrespective of Basel II. This cannot be prevented by capital adequacy rules nor should it be the objective of capital adequacy rules. Perhaps some other form of regulation can address that. Even under the present rules, a large bank can reduce capital through some form of regulatory arbitrage and use it to buy another (say, smaller) bank.

Question 7: *The agencies request comment on whether U.S. banks subject to the advanced approaches in the proposed rule (that is, core banks and opt-in banks) should be permitted to use other credit and operational risk approaches similar to those provided under the New Accord. With respect to the credit risk capital requirement, the agencies request comment on whether banks should be provided the option of using a U.S. version of the so-called “standardized approach” of the New Accord and on the appropriate length of time for such an option.*

The products in on and off balance sheets of large US banks (core banks and even likely opt-in banks) has become sufficiently complex that the Standardized Approach is, objectively speaking, inadequate. Also it does not behoove US as the leader in banking and finance to have its internationally active banks in the Standardized Approach, even if the option existed on paper. But more option is always preferred to less.

Since US Basel 1A (proposed) is similar to but not the same as Standardized Approach of Basel II, it is a little confounding to have some banks in Basel II Advanced, some in Basel II Standardized and some in Basel 1A.

Considering the paucity of default data on certain niche portfolios, it makes sense to permit (for the time being) Standardized Approach for those portfolios while Advanced Approach is applied to all other portfolios. By definition, the niche portfolios have to be small compared with the total portfolio size of the (core or opt-in) bank. This has been done in some other jurisdictions outside the US.



The proposed rule excludes assets held in an insurance underwriting subsidiary of a BHC because the New Accord was not designed to address insurance company exposures.

Question 8A: *The Board seeks comment on the proposed BHC consolidated non-insurance assets threshold relative to the consolidated DI assets threshold in the ANPR.*

The NPR provision is more in line with BCBS Basel II. The ANPR provision is not. To that extent, the NPR provision is preferred.

Capital is in relation to the risk of (all) assets. "DI assets" is not a conceptually defensible idea. Determining the cut-off based on all consolidated non-insurance assets is more defensible because after all the purpose is capital required to support the risks associated with the BHC.

A bank that is subject to the proposed rule either as a core bank or as an opt-in bank would be required to apply the rule unless its primary Federal supervisor determines in writing that application of the rule is not appropriate in light of the bank's asset size, level of complexity, risk profile, or scope of operations.

Question 8B: *The agencies seek comment on the proposed scope of application. In particular, the agencies seek comment on the regulatory burden of a framework that requires the advanced approaches to be implemented by each subsidiary DI of a BHC or bank that uses the advanced approaches.*

A subsidiary DI (deposit insurance) of a BHC may not have the size of portfolio and scale to make investments needed to qualify for Basel II Advanced Approaches. Its internal risk management also may be analytically weak making it a big cultural hurdle to implement Basel II Advanced Approaches. Even though it can rely on the expertise available in the BHC, it will be too much of a burden.

It is with this burden in mind that the agencies have come forth with Basel 1A for smaller banks and BHCs. The same principle can be applied to a stand-alone DI subsidiary of a BHC.

Question 9: *The agencies seek comment on the application of the proposed rule to DI subsidiaries of a U.S. BHC that meets the conditions in Federal Reserve SR letter 01-01 and on the principle of national treatment in this context.*

This provision does not accord fair treatment to equal parties. The minimum capital ratios (leverage ratios) are (i) inconsistent with the principle that capital should be risk sensitive – an objective of Basel II and good risk management; (ii) a higher leverage ratio does not necessarily mean lower risk to draw on deposit insurance. A DI subsidiary (or for that matter DI bank) should not be required to meet the minimum capital ratios.



The transitional floor calculations described above are linked to the general risk-based capital rules. As noted above, the agencies issued the Basel IA ANPR outlining possible modifications to those rules and are developing an NPR in this regard. The agencies are still considering the extent and nature of these modifications to the general risk-based capital rules and the scope of application of these modifications, including for banks that transition to the advanced approaches. The agencies expect banks that meet the threshold criteria in section 1(b)(1) of the proposed rule (that is, core banks) as of the effective date of the rule, and banks that opt-in pursuant to section

1(b)(2) at the earliest possible date, will use the general risk-based capital rules in place immediately before the rule becomes effective both during the parallel run and as a basis for the transitional floor calculations. Other changes to the general risk-based capital rules (outside the scope of the changes outlined in the Basel IA ANPR) may be considered by the agencies, as appropriate.

Question 10: *The agencies seek comment on this approach, including the transitional floor thresholds and transition period, and on how and to what extent future modifications to the general risk-based capital rules should be incorporated into the transitional floor calculations for advanced approaches banks.*

Banks' computation of risk-based capital requirements under both the general risk-based capital rules and the advanced approaches will help the agencies assess the impact of the advanced approaches on overall capital requirements, including whether the change in capital requirements relative to the general risk-based capital rules is consistent with the agencies' overall capital objectives.

A floor which is more risk sensitive is always preferred to a floor that is not. Basel 1A is certainly going to be more risk sensitive than the current general risk-based capital rules. Since Basel II and Basel 1A NPRs have overlapped, the floors for the first three years of application should be based on Basel 1A calculations.

Even if Basel 1A is not finalized by the time Basel II parallel runs start, the floors in the second and third years can be based on Basel 1A.

Basel 1A may add the complexity of maintaining an additional set of books (more so or in addition to current Basel 1). But that burden is less of an evil than having a non-risk-sensitive floor.

Once all transactions are pulled and analyzed (for economic capital or for Basel II Advanced during the parallel run) the big effort is over. Maintaining more than one set of books (which means back-end calculations or at most re-bucketing) is much less of an effort in comparison. Therefore, moving to Basel 1A as floor at any point is the preferred way.

However, if Basel IA also has a floor that needs to be satisfied (e.g. 95% or 90% of the current general risk based capital rule) during the Basel IA transitional period -- than for Basel II banks, using Basel IA as a floor or current rule as a floor, does not make much



difference. Therefore, if Basel II banks are required to use some percentage of Basel IA as a floor, this floor should not be based on a percentage of Basel I.

Question 11: *The agencies seek comment on what other information should be considered in deciding whether those overall capital goals have been achieved.*

The answer to this question is the same as the answer for Question 5.

The agencies are proposing to make 2008 the first possible year for a bank to conduct its parallel run and 2009-2011 the first possible years for the three transitional floor periods.

Question 12: *The agencies seek comment on this proposed timetable for implementing the advanced approaches in the United States.*

The time line seems to be too aggressive in view of the following:

- a. Basel II has become irrevocably intertwined with Basel 1A in the US.
- b. Basel II NPR comment period has been extended to perhaps end March, 2007.
- c. Comments on Basel II NPR and Basel 1A NPR will have to be dealt with together by the agencies (the whole reason the Basel II NPR comment period has been deferred, so that the two comment periods coincide) taking more time than simply dealing with comments on Basel II NPR.
- d. As a result the Basel II NPR is not likely to be finalized till late in 2007.

From late 2007 to January 2008 (when parallel run is proposed to start) may be too short a time and cause too much burden on both banks and local regulators for completing the qualification process. It will almost certainly keep the opt-in (since they have the choice) banks from opting in on day one.

Allowing Standardized Approach (see comment for question 7) for niche portfolios may shorten the qualification process.

Question 19(ii): *Whether the agencies should define operational loss in terms of the effect an operational loss event has on the bank's regulatory capital or should consider a broader definition based on economic capital concepts*

Capturing/quantifying indirect losses such as lost opportunity or forgone income is very difficult, and especially so if it has to be done in a manner that allows comparability from one institution to the next. For this reason we feel that regulatory capital should be based on direct financial losses, as has been proposed.



In all mergers and acquisitions involving a core or opt-in bank, the acquiring bank must submit an implementation plan for using advanced approaches for the merged or acquired company to its primary Federal supervisor within 30 days of consummating the merger or acquisition. A bank's primary Federal supervisor may extend the transition period for mergers or acquisitions for up to an additional 12 months. The primary Federal supervisor of the bank will monitor the merger or acquisition to determine whether the application of the general risk-based capital rules by the acquired company produces appropriate risk weights for the assets of the acquired company in light of the overall risk profile of the combined bank.

Question 20: *The agencies seek comment on the appropriateness of the 24-month and 30-day time frames for addressing the merger and acquisition transition situations advanced approaches banks may face.*

A 24 month (extendable to 36 months) period is generally sufficient to transition the combined bank to Basel II Advanced Approaches when one of the banks in the merger is a core bank or a bank that has already opted-in.

In case this provision applies to a situation where neither of the banks involved in the merger is a core or a bank that has already opted-in, but the combined entity satisfies the definition of a core bank, then 36 months is the more appropriate time frame.

The 30 day period for submission of an implementation plan is too short. The turmoil that usually accompanies a merger of (almost) equals takes some time to settle down. A 30-day deadline can be met only if this becomes part of the due diligence before the merger takes effect. A 90-day period is more feasible.

The agencies are considering restating the elements of tier 1 and tier 2 capital, with any necessary conforming and technical amendments, in any final rules that are issued regarding this proposed framework so that a bank using the advanced approaches would have a single, comprehensive regulatory text that describes both the numerator and denominator of the bank's minimum risk-based capital ratios. The agencies decided not to set forth the capital elements in this proposed rule so that commenters would be able to focus attention on the parts of the risk-based capital framework that the agencies propose to amend.

Question 21: *Commenters are encouraged to provide views on the proposed adjustments to the components of the risk-based capital numerator as described below. Commenters also may provide views on numerator-related issues that they believe would be useful to the agencies' consideration of the proposed rule.*

The debt, debt-like, equity, equity-like and hybrid instruments that a financial institution can use to raise funds have expended a lot in the last decade. It is, therefore, a good thing to revisit what constitutes Tier 1 capital, what constitutes Tier 2 capital and even the question of how many tiers should be there. These are all numerator-related issues.



However, restricting some particular vehicle type to a maximum ceiling (absolute or percentage of Tier 1 or of Tier 2) is counter-productive since it dampens creative financing. An example in point is the restriction of 15% on (tax-advantaged) Trust-preferred for Basel II banks. This only makes it harder for opt-in banks to decide to opt in.

The agencies generally propose to treat losses that are related to both operational risk and credit risk as credit losses for purposes of calculating risk-based capital requirements. For example, where a loan defaults (credit risk) and the bank discovers that the collateral for the loan was not properly secured (operational risk), the bank's resulting loss would be attributed to credit risk (not operational risk). This general separation between credit and operational risk is supported by current U.S. accounting standards for the treatment of credit risk.

The proposed exception to this standard is retail credit card fraud losses. More specifically, retail credit card losses arising from non-contractual, third party-initiated fraud (for example, identity theft) is to be treated as external fraud operational losses under this proposed rule. All other third party-initiated losses are to be treated as credit losses. Based on discussions with the industry, this distinction is consistent with prevailing practice in the credit card industry, with banks commonly considering these losses to be operational losses and treating them as such for risk management purposes.

Question 27: *The agencies seek commenters' perspectives on other loss types for which the boundary between credit and operational risk should be evaluated further (for example, with respect to losses on HELOCs).*

Inclusion of credit losses resulting from operational events (except fraud losses in credit cards) as credit risk is mainly a compromise in order to take full advantage of (sparsely available) LGD data with some banks. The historical LGD databases typically include all credit losses, whether resulting from operational mistakes or not. It is impossible to go back and decouple credit losses resulting from operational mistakes from such databases. Many of these losses are booked against reserves, as allowed under US GAAP.

Inclusion of credit losses resulting from operational events (except fraud losses in credit cards) as credit risk undermines the importance of operational risk – particularly the emphasis on the fact that such losses are generally preventable.

Credit losses resulting from operational events generally happen when the economy is sour. True credit losses are also large at the same time. On the face of such large loss numbers, credit losses resulting from operational events may get swept under the carpet.

On the other hand, credit losses resulting from operational events are large in magnitude compared to most losses from purely operational events. And there is no reason to suppose that large operational losses and credit losses resulting from operational events



happen at the same time. Therefore, credit losses resulting from operational events get all the attention and root cause analysis that they deserve.

Banks can (going forward) collect information on credit losses resulting from operational events for risk management purposes while counting them towards credit risk for regulatory capital purposes.

Credit losses resulting from operational events in HELOC (not just fraud losses in HELOC) generally get subsumed in the net-to-gross charge-off calculation, which is computed at a portfolio level (unlike LGD data on wholesale, which is recorded for each transaction). It will be impossible to go back and decouple credit losses resulting from operational mistakes from such databases.

As to fraud losses in HELOC or any other portfolio, banks generally maintain a separate fraud database but that does not make it any easier to separate credit losses from the credit-operational boundary losses in the existing databases.

Boundary between the Proposed Rule and the Market Risk Amendment (MRA). Positions currently subject to the MRA include all positions classified as trading consistent with GAAP. The New Accord sets forth additional criteria for positions to be eligible for application of the MRA. The agencies propose to incorporate these additional criteria into the MRA through a separate notice of proposed rulemaking concurrently published in the Federal Register. Advanced approaches banks subject to the MRA would use the MRA as amended for trading exposures eligible for application of the MRA. Advanced approaches banks not subject to the MRA would use this proposed rule for all of their exposures.

Question 28: *The agencies generally seek comment on the proposed treatment of the boundaries between credit, operational, and market risk.*

The boundary between credit risk and operational risk has been discussed in Comment 27 above.

The boundary between credit risk and market risk are commented on as follows:

- a. The market risk NPR proposes prescriptive rules which bifurcates the trading book into those positions that are covered by the proposed market risk rules and those positions that would have their risk weighted assets calculated by banking book rules (e.g. for equity investments or securitization)
- b. This bifurcation essentially requires separate classification for accounting and regulatory purposes. Banks will have to maintain two parallel systems for classifying transactions and for calculating and reporting.



- c. A bank will calculate and disclose VAR for **all** positions in its trading book since analysts and investors would want to know that. But for regulatory purposes, VaR will have to be calculated for only a **part** of the trading book. Under Pillar 3, the latter VaR is most likely to be disclosed. Thus the two different disclosed VaRs will cause confusion for the investors.
- d. All assets and liabilities in the trading portfolio should be included in the VAR for market risk. The only exceptions should be demonstrated economic hedges (as defined under FAS 133) consisting of: (i) interest rate derivatives that are entered into to hedge the interest rate risk of banking book positions; and (ii) credit derivatives that are entered into to hedge credit risk.

Question 61: *The agencies seek commenters' views on all of the elements proposed to be captured through the public disclosure requirements. In particular, the agencies seek comment on the extent to which the proposed disclosures balance providing market participants with sufficient information to appropriately assess the capital strength of individual institutions, fostering comparability from bank to bank, and reducing burden on the banks that are reporting the information.*

The Pillar Three public disclosure requirements proposed definitely achieve the Basel II objective of developing disclosure standards that will provide meaningful, forward-looking, and relevant information to the market in a manner that enhances market discipline. Banks' annual reports and other public disclosures do not include enough information for an investor to get an idea of the long-term risk (of earnings shortfall from credit and operational risks) inherent in their portfolios or assets. So much so that the mandatory nature of the Pillar Three disclosures about a bank's portfolio is actually welcome. Our argument is not a naïve argument that "more disclosure is better." In fact we will argue (see later paragraphs) that while disclosure is important, more disclosure is not necessarily better.

The current disclosures relating to risk variables are generally contemporaneous of past trends of NCO and NPL with some guidance into the near future. Such disclosures are not forward looking and rarely have much information content for most quarters (the business cycles are such that high credit losses happen once in 30 or 40 quarters). The disclosures in the proposed rules not only provide investors with the portfolio (risk) composition but also provide information that can be used to infer long-term risks. In fact, research suggests that banks across the globe that disclose information regarding their portfolio have lower stock volatility¹. However, the impact of excess disclosure could not be tested.

The disclosures in the proposed rules minimizes the importance of guidance and soft matters like "personal equation of an analyst with a bank" and enables sophisticated

¹ Baumann, U., and E. Nier. September 2004. "Disclosure, volatility, and transparency: An empirical investigation into the value of bank disclosure." Federal Reserve Bank of NY Economic Policy Review.



market participants to gather objective knowledge and understanding of risk management policies and risk profile of reporting institutions. In this regard, the Pillar Three disclosure requirements may make the average bank stock analyst less relevant but they certainly are beneficial to (long-term) investor community at large.

Once all transactions are pulled and analyzed (for economic capital or for Basel II Advanced) the big effort is over. Most of the portfolio disclosure requirements are, thereafter, marginal work. It may appear daunting, at first sight, to traditional accounting and investor relations professionals, who are not accustomed to risk related variables regarding the significant amounts of input that go into economic capital calculations. But they are not, if a bank has to do everything that is necessary to qualify for Advanced IRB and AMA (or is doing for a sophisticated implementation of enterprise-wide economic capital framework). Therefore, it is a less important concern that the proposed disclosures balance sufficiency of information to investors on the one hand and the burden on the reporting institutions on the other.

However, we noticed that U.S. Basel II banks are required to disclose its quantitative data quarterly, while the rest of Basel II countries only need to disclose it semi-annually. We believe that semi-annual reporting is sufficient and will not create a regulatory burden.

A more important concern is that the proposed disclosures balance sufficiency of prescribed information on the one hand and the possibility of misleading investors on the other. Banks need to have the flexibility of providing explanatory detailed information beyond the mandatory disclosure requirements, in case of anticipated misinterpretation. For example, if the requirement is for banks to disclose their loss estimates against actual outcomes this may lead investors to the wrong conclusions even over a reasonably long period of time. Data that can facilitate apples to apples comparison between loss estimates and actual outcomes are hard to come by for any bank.

Pillar Three disclosure applied to mandatory and opted-in banks may force other publicly traded large banks to opt in whether they want it or not. This unintended consequence may result from the following distinct possibility: within a few quarters of several Advanced Approach banks reporting the disclosures in their annual reports, analysts would expect all publicly traded institutions they follow to provide them (the analysts) with the same or similar amount of information. In fact they would demand it of those publicly traded banks irrespective of what the regulators say. In order to generate such disclosure information, such publicly traded banks would have to make most of the investments required to qualify for Basel II Advanced Approaches. In other words they would be forced to opt-in.



Additional Comment and Request for Clarification

1. Regarding one of the requirements for operational risk quantification system, the NPR states:

“As part of its estimation of its operational risk exposure, a bank must demonstrate that its unit of measure is appropriate for the bank’s range of business activities and the variety of operational loss events to which it is exposed. The proposed rule defines a unit of measure as the level (for example, organizational unit or operational loss event type) at which the bank’s operational risk quantification system generates a separate distribution of potential operational losses. A bank must also demonstrate that it has not combined business activities or operational loss events with different risk profiles within the same loss distribution.” (Federal Register Vol. 71 No. 185 pp. 55852)

Comment for the underlined requirement:

While we understand and appreciate the rationale behind this requirement, because of lack of data there will be severe limitations in “quantifying” the risk profile of sub-units that make a unit. The requirement to demonstrate the appropriateness of units of measure appears to set a very high standard, one that is quite likely impractical to implement.

2. Regarding the four elements in operational risk, the NPR states:

“A bank must have an operational risk data and assessment system that incorporates on an ongoing basis the following four elements: internal operational loss event data, external operational loss event data, results of scenario analysis, and assessments of the bank’s business environment and internal controls.” (Federal Register Vol. 71 No. 185 pp. 55851)

Are the four elements of operational risk quantification: internal operational loss event data, external operational loss event data, results of scenario analysis, and assessments of the bank’s business environment and internal controls, all absolute requirements? Within the flexibility of the weights of these four factors, can one (or more) of the weights be set to zero? For example, if an institution can justify a model without results of scenario analysis, will that be acceptable?

3. Regarding operational loss collection threshold, NPR states:

“A bank may refrain from collecting internal operational loss event data for individual operational losses below established dollar threshold amounts if the bank can demonstrate to the satisfaction of its primary Federal supervisor that the



thresholds are reasonable, do not exclude important internal operational loss event data, and permit the bank to capture substantially all the dollar value of the bank's operational losses." (Federal Register Vol. 71 No. 185 pp. 55852)

Does this imply that it is necessary to empirically capture a high percentage (say 99%) of all operational losses on a dollar basis? Or can the smaller losses be modeled, e.g. using truncated loss severity distributions?