Capital One Financial Corporation
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McLean, VA 22102

March 26, 2007

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Ave., N.W.
Washington, DC 20551
Docket No. R-1261
Regs.comments@federalreserve.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552
Attn: No. 2006-33
Regs.comments@ots.treas.gov

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, DC 20219
Docket No. 06-09
Regs.comments@occ.treas.gov

Mr. Robert E. Feldman
Executive Secretary
Attn: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
RIN 3064-AC73
comments@FDIC.gov

Re: Risk-Based Capital Standards: Advanced Capital Adequacy Framework (Basel II)

Dear Sirs and Madams:

Capital One Financial Corporation (Capital One) is pleased to submit comments on the federal banking agencies' Joint Notice of Proposed Rulemaking on the subject of the Basel II capital rules.[1]

[1] 71 Fed. Reg. 55830 (Sept. 25, 2006).

Capital One Financial Corporation is a financial holding company whose principal subsidiaries, Capital One Bank, Capital One, F.S.B., Capital One Auto Finance, Inc., Capital One, N.A., and North Fork Bank, offer a broad spectrum of financial products and services to consumers, small businesses, and commercial clients. As of December 31, 2006, Capital One's subsidiaries collectively had $85.5 billion in deposits and $146.2 billion in managed loans outstanding, and operated more than 700 retail bank branches. Among its product lines, Capital One is one of the largest issuers of Visa and MasterCard credit cards in the world. Capital One is a Fortune 500 company and is included in the S&P 100 Index.

Consistent with the International Basel II Framework, U.S. Banks Should Be Allowed a Choice of Suitable Capital Regimes.

The Basel II Capital Accord, as framed by the Basel Committee on Banking Supervision, allows banks three versions of capital regimes to choose from. They range from the simple and straightforward (Basel Standardized) to the enormously complex and expensive (Advanced) which is the subject of this rulemaking. Banks elsewhere in the world are allowed a choice. Banks in the United States should be as well. It is not critical that the choices be those described in the Basel Accord in all details. What is important is that there be a choice between a highly risk-sensitive regime that offers, in exchange for the large expense and effort required to implement it, the possibility of reduced capital levels reflecting the benefits of state-of-the-art risk management, and on the other hand, a simpler and cheaper regime that does not offer that possibility but is easier to implement and use. The proposed Basel IA regime is such an option.

Building the data management and risk assessment infrastructure required by the Advanced version of Basel II is enormously expensive. Cost estimates by industry consultants range from $50-100 million for every $100 billion of assets. Banking organizations will have a legitimate incentive to undertake such huge expenditures if they are thereby enabled to actually reduce their risk, which would be reflected in a lower capital charge. But that is what the Agencies are determined to prevent. The Basel II Advanced regime has been hemmed in with many safeguards to prevent significant reductions in capital, notably including the indefinite continuation of the wholly non-risk-sensitive leverage ratio.

The Agencies have erected those safeguards because they do not trust the reliability of the Basel II Advanced methodology. In part, this reflects the results of Quantitative Impact Study 4, and in part possibly a deeper unease with the methodology. But if the Agencies consider the methodology to be untrustworthy, they should not compel banking organizations to spend hundreds of millions of dollars to build the infrastructure necessary to support it. They should instead permit banking organizations to use simpler capital regimes. A simpler regime has maintained industry capital at robust levels for some time, augmented by supervisory review as appropriate, for example under the Board's Supervisory Letter SR 99-18 (July 1, 1999).

Mandating a hugely expensive capital regime that the Agencies do not trust, and have surrounded with restrictive safeguards, creates multiple potential competitive inequities. It creates a competitive imbalance with European banks who are being allowed to implement Basel II Advanced without those constraints; and it creates competitive imbalance with the majority of U.S. banks which are not compelled to adopt Basel II Advanced and are allowed to retain the much simpler and cheaper Basel I (or Basel IA if they prefer).

In addition, compelling banks in some cases to hold higher capital levels than would be required by the Basel II Advanced risk-assessment methodology may perversely incent banks to hold riskier, higher-return assets, commensurate with the capital levels that they are required to maintain.

All of these effects can be mitigated by allowing bank managements to choose from an array of suitable capital regimes, and we urge the Agencies to allow that choice.

The Basel II Advanced Regime Requires Credit Card Capital Levels that Are Too High for Several Identifiable Reasons.

In contrast to the many types of banking assets for which the Basel II Advanced regime holds the possibility of reduced capital charges, the Agencies correctly observe that "[o]verall capital requirements for credit cards could increase," and that "[t]his raises the possibility of a change in the competitive environment among banking organizations subject to the new Basel II-based capital rules, nonbank credit card issuers, and banking organizations not subject to the new Basel II-based capital rules."[2] We submit that the imposition of differential capital rules could very plausibly cause a reallocation of credit card assets away from entities subject to the Basel II Advanced rules and toward entities that are subject to capital rules less prejudicial to credit cards. Some such reallocation might not be troublesome to the Agencies if the various aspects of the capital rules applicable to credit cards were well grounded, but as we will demonstrate, they are not.

The AVC Factor Is Too High.

As the Agencies note, "asset value correlation (AVC) factors … have a significant impact on the capital requirements generated by the formulas."[3] That is certainly so for credit cards, which with other qualifying revolving retail exposures are assigned an AVC of 4 percent. The Agencies concede that, for non-mortgage retail exposures, the historical data available to them for the purpose of estimating the correlations was "limited," and that, "[a]s a result, supervisory judgment played a greater role."[4]

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[2] 71 Fed. Reg. at 55908.

[3] *Id.* at 55834.

[4] *Id.*

In fact, Capital One's experience indicates that, for our credit card portfolios, the actual AVC is less than 2 percent. To derive AVC estimates, we first segmented millions of accounts into homogeneous risk buckets using internally generated risk scores that rank-ordered borrowers by likelihood of default. We then measured the volatility of historical loss rates for each risk bucket and derived the Loan Default Correlation (LDC) among borrowers. LDCs were then translated into AVCs using a mathematical formula. These results, which anchor our internal economic capital modeling, show AVCs for credit cards well below 2 percent across the entire credit spectrum. We see no reason to believe that Capital One's credit card portfolios are materially different from those of the industry as a whole in this respect.

Instead of mandating an AVC figure that is known by the Agencies not to be well grounded in historical data available to them, and that contributes to a high capital charge for credit cards that may artificially drive competitive changes in the industry, we urge the Agencies to enable a banking organization and its supervisor to use an AVC for credit cards other than 4 percent if the bank can satisfy its supervisor that the different AVC figure is well grounded in the bank's own historical data.[5]

Capital Charges for Securitized Portfolios Subject to Early Amortization Provisions Are Too High.

The presence of an early amortization provision in a securitization structure does not, in our view, justify the assessment of a capital charge on the investors' interest in the portfolio. In a securitization, the risk of credit loss passes to the investors. While the possibility of early amortization is genuine, it is fundamentally a risk of liquidity, not credit. Unexpected credit losses may contribute to triggering early amortization, but those losses are shared among the credit card issuer and investors as dictated by the terms of the securitization. Once early amortization commences, funding, not credit performance, is the issuer's primary concern. For this reason, early amortization is equivalent to other liquidity crises that a lender might face. The recognized means for dealing with liquidity risk is not capital, but sound liquidity management: funding-source diversity, back-up lines of credit, and a strong capital market presence. Sound liquidity management is likewise the appropriate instrument for addressing risk of early amortization.

Even if one were to adopt the Agencies' position and treat early amortization as an instance of credit risk rather than liquidity risk, the credit conversion factors (CCFs) that the Agencies prescribe are too high. That result is cogently demonstrated by the Risk Management Association's responses to the Agencies' Questions 52-54, responses that Capital One endorses and joins. The RMA convincingly shows that, taking the various elements of the proposed capital treatment together (including the fact that most U.S.

[5] We understand that the 4 percent AVC proposed for credit card portfolios in Basel II was influenced by negotiated agreement with international regulators – as evidenced by the change in AVC treatment between the Third Consultative Paper and the final Accord. However, we submit that accurate risk-weighting for U.S. portfolios must be based on the best data that are specific to the U.S. credit card industry.

credit card securitizations provide for early amortization that the Agencies would likely define as "non-controlled"), the capital requirement for a securitized portfolio that is approaching or is actually in early amortization status would actually be higher than the capital requirement under Basel II Advanced if the bank had retained those receivables. That result makes no sense, because securitization, including with early amortization provisions, in fact does shift significant credit risk in the portfolio to investors. Hence the proposed capital requirement is excessively high, and may discourage use of genuinely risk-shifting securitization vehicles – a result that is in nobody's interest.

Notwithstanding the artificially high CCFs that the Agencies propose, Capital One would prefer that approach, tied as it is to excess-spread levels and hence reflective of the state of credit risk in the portfolio, to a flat CCF for the entire investors' interest such as the Agencies are considering for securitizations with controlled early amortization provisions (Question 54).[6] That approach is not risk-sensitive and should be avoided.

Proposed Treatment of ALLL Is Inconsistent with How Credit Card Lenders Manage Expected Credit Losses.

A third factor driving the unnecessarily high capital charge for credit card portfolios is the Agencies' proposed treatment of the allowance for loan and lease losses (ALLL). Under the current capital rules, ALLL is includable in tier 2 capital (up to 1.25 percent of risk-weighted assets). But under the Basel II proposal, ALLL is not includable in capital except to the extent that it exceeds Expected Credit Losses (ECL) (and ECL is deducted from assets). This treatment, which results in a higher capital charge, is inappropriate, because in a soundly run lending institution interest rates on loans are set to cover expected loses, as well as interest expenses, operating costs, and return on equity. The proposed treatment of ALLL is especially severe for credit cards, because ECL for credit cards is higher than for other forms of lending. Yet, credit cards, like other loans, are priced to cover the lender's expected credit losses in the portfolio. A recent study shows that credit card interest income is sufficient to cover ECL through the credit cycle, including during credit downturns.[7] Hence credit cards are appropriately priced and should not suffer the additional unnecessary burden of having their ALLL backed out of the capital that is held against them.

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[6] 71 Fed. Reg. at 55894.

[7] John Mingo, "Future Margin Income and the EL Charge for Credit Cards in Basel II," The RMA Journal 46 (Sept. 2006).

Capital One appreciates the opportunity to comment on the Agencies, Joint Notice of Proposed Rulemaking. If you have any questions about this matter and our comments, please call me at (703) 720-2255 or Dr. Geoffrey Rubin at (703) 720-3102.

Sincerely,

/s/

Christopher T. Curtis
Associate General Counsel
Policy Affairs