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October 27, 2008 **Via Email**

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Secretary
Board of Governors of the
Federal Reserve System
20th Street & Constitution Ave., NW
Washington, DC 20551

Office of the Comptroller of the Currency
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Mail Stop 1-5
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Mr. Robert E. Feldman
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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: OTS-2008-0002

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework; 73 Federal Register 43982; July 29, 2008; **OCC:** Docket ID: OCC-2008-0006, RIN 1557-AD07; **FRB:** Docket No. R-1318; **FDIC:** RIN 3064-AD29; **OTS:** Docket No. 2008-002, RIN 1550-AC19

Ladies and Gentlemen:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the Joint Notice of Proposed Rulemaking (NPR) on Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework (the Standardized Approach),[2] as issued by the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) (collectively, the "Agencies").

The intended purpose of the NPR is to create a new risk-based capital framework based on the Standardized Approach for credit risk; the Basic Indicator Approach for operational risk described in the capital adequacy framework – "International Convergence of Capital Measurement and Capital

[1] *The American Bankers Association brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ more than two million men and women.*

[2] 73 *Fed. Reg*. 43982 (July 29, 2008).

Standards: A Revised Framework" (New Accord) released by the Basel Committee on Banking Supervision; and related disclosure requirements. While this proposal generally parallels the New Accord, the NPR notes that it diverges in some respects to address unique characteristics and risk profiles of the U.S. markets, including the proposed risk weighting for residential mortgage exposures. The Standardized Approach framework generally would be optional for banks, bank holding companies, and savings associations (banking organizations) that currently comply with the general risk-based capital rules (Basel I).

The ABA believes the Standardized Approach NPR is a significant improvement over the current Basel I rules and the Basel IA proposal as an option. We urge the regulators to adopt it in final form, albeit with several suggested changes that are intended to improve the extent to which the rule matches capital requirements to risk.

Areas in which we believe the rule could most benefit from changes are as follows:

- **Corporate Exposures**: For most banking institutions that will seriously consider or be required to adopt the Standardized Approach, the balance sheet is dominated by unrated and unratable commercial exposures that will see no benefit in risk sensitivity from the Standardized Approach, yet will be subject to an added operational risk capital charge. Therefore, we recommend that the rule provide more granularity in risk weights for major categories of corporate exposures. One way to achieve this would be to use loan-to-value (LTV) ratios to risk-weight corporate exposures such as multi-family residential mortgages and commercial real estate (CRE). We suggest that the Agencies look for additional risk divisions within the broad corporate category.

- **Retail Exposures**: The rule should clarify what a "well-diversified portfolio" is for purposes of the rules governing regulatory retail exposures. While a lower risk weight for retail exposures is appropriate, banks will have a difficult time knowing whether that risk weight applies without further clarification of what meets the "well-diversified" standard.

- **Operational Risk**: The rule should provide flexibility to banking organizations by including a more refined measurement of capital needed for operational risk where appropriate. We recommend that the final rule allow banks to make a voluntary choice among three options: (1) the NPR's proposed Basic Indicator Approach (BIA), (2) the International Accord's Alternative Standardized Approach option, and (3) the Advanced Measurement Approaches (AMA) as outlined in NPR.

These points, as well as additional suggestions for improving the rule, are set forth below.

Discussion

Scope. The Agencies invite comment on the threshold question of the scope of the rule. As proposed, any bank that is not a "core" bank (*i.e.*, a bank obligated to comply with the

Advanced Approaches as recently adopted[3]) would have the option to use the Standardized Approach or continue to apply the current risk-based capital rules (Basel I). The ABA believes the Standardized Approach would be a valuable option for banks to consider as another means of assessing risk and measuring capital levels. There will be many banks, however, that will prefer not to expend the resources in order to adopt a system that may yield a more risk-sensitive allocation of capital. Thus, we appreciate the fact that the Standardized Approach will be optional for most banks, and we urge the Agencies to retain this flexibility in the final rule.

The Agencies have been clear that there will be some banks that the Agencies will require to use the Standardized Approach. The proposal states that the Agencies will look at asset size, complexity, risk profile, and scope of operations to see if a bank stands out in one or more of these criteria to a degree that its risk exposure is not adequately captured under the Basel I standard. In this case, the bank may be directed by its supervisors to adopt the Standardized Approach. Such action would essentially usurp the authority of a bank's management, which is responsible for the proper allocation of bank resources and measurement of the bank's risk and the capital needed to support that risk. If a supervisor believes that a bank's risk management is insufficient, the supervisor should address this through more targeted supervisory responses rather than impose the cost and disruption on the bank of adopting a new set of capital rules.

As a general principle, the ABA recommends that the final rule provide the flexibility of allowing banks that grow to the size and complexity of banks that are using the Advanced Approaches to remain on the Standardized Approach. Banks that are currently in the process of implementing the Advanced Approaches likely have invested too much for the Standardized Approach to be a meaningful option. However, there is much in the Standardized Approach that could be an attractive option even for a very large bank, and thus we recommend that there be no automatic triggers that require a bank on the Standardized Approach to adopt the Advanced Approaches.

The ABA also recommends that the final rule allow any bank using the Standardized Approach to have the flexibility to use the Basel I capital rules for *de minimis* exposures. The approach taken in the Standardized Approach (as well as in Advanced Internal Ratings-Based approach) uses a principle of conservatism. While this is potentially useful, we recommend that the rule state in addition that a bank may elect to assign capital based on Basel I for asset classes that, in the aggregate, do not exceed some specified percentage of capital. This would minimize an impact that otherwise may cause a bank to conclude that the burden of adopting the Standardized Approach for all assets outweighs the benefits in terms of enhanced risk management and sensitivity. This practice would also allow banks to progress toward more risk-sensitive capital rules as soon as they meet essentially all of the requirements.

Timing. In the unique situation when a regulator requires a bank to use the Standardized Approach, the bank will need a reasonable time period to implement the rule. We recommend that a bank be given a minimum of 24-months' advance notice from its regulator before being required to adopt the Standardized Approach.

[3] *See* 72 *Fed. Reg*. 69288 (Dec. 7, 2007).

Similarly, a bank that adopts the Standardized Approach should be allowed sufficient time to bring all its entities into conformity following a merger or acquisition. One approach would be to allow the same amount of time that is allowed for banks under the Advanced Approaches to bring an acquired or merged unit into conformity – namely, 24 months, extendable to 36 months with supervisory permission. Banks likely will want to integrate systems as quickly as possible; thus in those situations where it is feasible, the bank will compute regulatory capital on the acquired assets under the Standardized Approach sooner than 24 months. However, the final rule should recognize that integration is not an easy event and that banks should not be held in violation of a rule because of an artificially short deadline.

Risk weights: Exposures to depository institutions. The proposal would risk-weight exposures to depository institutions based on the issuer rating of the entity's sovereign of incorporation. As a general matter, an exposure to a U.S. institution would be weighted one category less favorable than the rating assigned to a claim against the U.S. This means that exposures to U.S. depository institutions generally would be weighted at 20 percent, which would result in no change to the current rule.

While the ABA generally agrees with the NPR's treatment of exposures to depository institutions, we recommend that the final rule clearly state that exposures evidenced by certificates of deposit of less than or equal to an amount that is fully insured by FDIC insurance should be risk-weighted at 0 percent instead of 20 percent. We understand that the regulators are concerned that there is the possibility of fraud in these transactions and thus are inclined to keep such exposures at 20 percent. However, we strongly believe that the regulators should send a strong, consistent signal that any obligation backed by the full faith and credit of the U.S. is essentially risk-free and therefore deserving of a 0 percent risk weight. Any transaction is susceptible to fraud; however, this concern should be kept separate from the underlying characteristics of the exposure at issue. Fraud by its very nature is a localized event. It can and should be addressed on a case-by-case basis, with no system-wide adverse effect on the risk-weighting of insured CDs. Morever, fraud risk is captured by the operational risk charge.

Risk weights: Corporate exposures. The NPR would permit a bank to elect one of two methods to risk-weight corporate exposures. A bank could either (1) risk-weight all of its corporate exposures at 100 percent without regard to external ratings; or (2) risk-weight a corporate exposure based on its applicable external or inferred rating. If a corporate exposure has no external rating, that exposure could not receive a risk weight lower than the risk weight that corresponds to the lowest issuer rating of the obligor's sovereign of incorporation.

The ABA believes the proposed approach fails to recognize the variety of risks in corporate exposures. Just as residential mortgage loans present different risks depending on the loan-to-value (LTV) ratio, so, too, do corporate exposures. Thus, the ABA recommends that the final rule include additional risk sensitivity within the corporate exposure bucket. One way to do this would be to reflect LTVs in the risk weight for corporate exposures. We recognize that corporate exposures (such as loans secured by CRE and multi-family housing) as a group, present different risk characteristics than do residential mortgage loans, and thus we propose a different – and more conservative – set of risk weights for CRE than is used for residential mortgages. Below is one option for risk weighting CRE exposures with varying LTV ratios:

LTV Ratios	Risk Weight
Up to 20 percent	20 percent
Over 20 percent up to and including 40 percent	35 percent
Over 40 percent up to and including 50 percent	50 percent
Over 50 percent up to and including 75 percent	75 percent
Over 75 percent	100 percent

If this (or a similar) approach is used, the regulation would need to explain how "value" is to be calculated. We recommend that the value of an asset be determined according to one of two approaches. Under the first approach (which is similar to the proposed rule's treatment of residential mortgages), the value would be equal to the lesser of the acquisition cost for the property (for a purchase) or the estimate of a property's value at the origination of the exposure or, at the institution's option, at the time of a restructuring. Under the second approach, value would be equal to the most recent valuation obtained by the institution for assets within the portfolio. Importantly, banks would ***not*** have the option of "cherry picking" and using origination values for some assets in the portfolio but updated values for others. Rather, if a bank were to select the second option, it would have to use the most recent valuations for all assets within the portfolio. Moreover, a bank would not be permitted to use just increased values obtained through the new valuations; it would have to use both increased and decreased valuations obtained in the course of the bank managing its commercial assets in a safe and sound manner. This would, of course, be subject to a bank's regulator's authority to require write-downs or reappraisals of property values for capital purposes in a declining market.

The ABA also recommends that banks be permitted to use internal risk ratings where the bank can demonstrate to its regulator's satisfaction that the bank's internal risk ratings have been adequately correlated to external default and loss ratings. In such cases, the applicable inferred internal rating can be used to risk-weight corporate exposures. For example, internal ratings (*e.g.*, loan gradings) could be mapped to external ratings and re-calibrated as necessary based on actual default and loss experience. This would be an alternative approach that, if properly applied, would more closely link risk and required capital, without full Internal Ratings-Based (IRB) implementation, and would therefore facilitate a smooth migration from the Standardized Approach to the IRB approach for those banks choosing to do so.

Risk weights: Regulatory retail exposures. The NPR risk-weights regulatory retail exposures at 75 percent. To qualify, the exposure must be to an individual or business in an amount that, when aggregated with all other exposures to that borrower, does not exceed $1 million. It also must be part of a "well diversified portfolio." The rule does not define what a well diversified portfolio is, but does invite comment on whether a specific numerical limit on concentration should be incorporated into the provisions for regulatory retail exposures. The proposal notes that the New Accord would allow a 0.2 percent limit on an aggregate exposure to one obligor as a measure of concentration within the regulatory retail portfolio, and invites comment on the use of such a threshold as well as other types of measures of portfolio concentration that may be appropriate.

The ABA supports applying a 75 percent risk weight to retail exposures, but we are concerned that the open-ended nature of this approach would severely diminish the utility of this

provision. As proposed, it has a "you know it when you see it" quality, making it effectively impossible for a bank to know whether a loan qualifies for the 75 percent risk weight. Moreover, this could result in significant variations from agency to agency and examiner to examiner, thereby further diminishing the extent to which this approach results in reliable risk-sensitive capital assignments.

In order for this approach to be viable, the regulators will need to provide more certainty about precisely how a portfolio is to be evaluated for diversification and how frequently. While a per-obligor test perhaps could be useful, the 0.2 percent threshold is too low for the banks that would be applying the Standardized Approach. For a bank that has a portfolio of $50 million, this threshold would equate to a $100,000 per obligor limit. For very large banks with large portfolios, 0.2 percent may be appropriate, but for mid-size banks or community banks that are thinking of adopting the Standardized Approach, the retail exposure provision would not capture a significant portion of the bank's business.

Similarly, we believe the cap of $1 million for all exposures to any one borrower will result in exposures being treated as corporate exposures, in many cases where the lower risk weighting assigned to retail exposures would be more appropriate. We note by way of comparison that the New Accord uses a limit of €1 million, which currently is worth approximately $1.3 million. Such a higher limit (not tied to a fluctuating foreign currency, of course) is appropriate here as well. To avoid the infeasibility of having a floating cap while at the same time preserving comparability to the rules applied abroad, we suggest that the U.S. regulators set the cap in the final rule at $1.5 million. That cap could then be indexed to inflation so that is does not become increasingly restrictive and outdated over time.

The final rule also should clarify how often compliance with the diversification test must be evaluated. Banks make loans every day and loans get paid off every day. Thus, the aggregate value of loans in the portfolio will not remain static. The rule needs to provide details about when diversification needs to be analyzed, and it should avoid imposing overly burdensome reporting requirements.

The ABA recommends that the final rule not require that geographic diversification be the sole (or even a mandatory) criterion for defining a "well diversified portfolio." Banks will likely have natural markets that they serve and indeed often are criticized for lending out of that market. If geographic diversity is a test for diversification, smaller banks would likely find the retail exposure classification of little value. If a bank wishes to demonstrate diversification stemming from a geographically dispersed portfolio, that should be permitted.

The final rule also needs to address what happens to the retail exposure portfolio if an asset in that portfolio exceeds the threshold. Presumably, that asset would be included in the corporate exposure portfolio for purposes of the capital rule without tainting the entire retail exposure portfolio, but we request that the final rule make this clear.

Risk-Weights: Residential Mortgage Exposures. The proposal uses LTVs to risk-weight first-lien residential mortgage loans secured by property that is owner-occupied or rented, prudently underwritten, not past due more than 90 days, and performing according to its original

terms. Stand-alone junior lien residential mortgages also are risk-weighted according to LTV. Exposures that are more than 90 days past due would receive a risk weight of 150 percent (or 100 percent if they have an LTV of no more than 90 and meet other qualifying criteria).

The ABA supports using LTV ratios to assign capital. Prudently underwritten residential mortgage loans historically have been low-risk assets, particularly when the borrower has a significant amount of equity in the home. We encourage the regulators to adopt the proposal, with the following changes.

First, consistent with the approach recommended above for CRE loans, banks should have the option of using one of two approaches in valuing the residential mortgage portfolio: either rely on values as of the time of origination (or restructuring) or rely on updated values. This would provide banks with a simpler option of relying on just the one valuation or the more risk-sensitive option of using updated valuations.

Second, while we recognize that pool-level private mortgage insurance (PMI) presents practical difficulties in determining which assets are protected, such PMI nevertheless can provide meaningful protection and should be considered when determining the loan amount. Pool-level PMI allocated proportionately among the loans, with an appropriate discount, should offset loan value in LTV. At a minimum, pool-level PMI should be considered under Pillar 2 when evaluating the adequacy of a bank's capital irrespective of the regulatory minimum capital standards under Pillar 1.

The regulators invite comment on whether factors in addition to LTV should be considered when determining the appropriate risk weights. While there are other factors (such as FICO scores or HMDA data) that lenders often use to determine risk, we believe there is a tradeoff between additional refinement and burden. Using LTV ratios without additional risk determinants strikes an appropriate balance. After the Standardized Approach has been implemented for some period of time, the regulators may want to consider if refinements to the risk-weighting, such as credit scores, are appropriate.

The regulators also invite comment on two alternatives for calculating the LTV ratio. The proposal requires a separate calculation for both funded and unfunded amounts, while the alternative calculates only a single LTV ratio representing a combined funded and unfunded amount. The ABA believes there are pros and cons to both the NPR's proposed and alternative calculation for the LTV ratio in determining mortgage risk-weighted exposures. Bankers see no difference in complexity between the alternatives, as both methods use the same input data. The preference for either of these LTV ratio calculations is likely to be bank-specific.

Those banks that envision ultimately adopting the Advanced Approaches view the alternative calculation as sufficiently similar to the Advanced Approaches calculation to make eventual transition to the Advanced Approaches easier. Moreover, banks that hold a larger volume of negative amortization products may prefer the alternative, given that the performance of the funded and unfunded portions behave more in tandem.

Community banks, on the other hand, believe the proposed approach better captures the risks more commonly seen in their mortgage portfolios. These banks are likelier to have proportionately more home equity lines of credit (HELOCs) than negative amortization products. There is likely to be less of a correlation between the performance of a HELOC and the funded portion of a loan than there is between the negative amortization features of a funded loan. Accordingly, these banks believe it would be appropriate to apply a final rule that treats the two components separately.

Given the relative merits of both approaches, we recommend that the final rule permit a bank to select the option that is most appropriate for its operations.

Risk-Weights: Past Due Exposures. The NPR would risk-weight exposures that are more than 90 days past due or on nonaccrual at 150 percent (or 100 percent in the case of residential mortgage loans meeting certain criteria, as noted above). The Agencies seek comment on whether, for those banking organizations that are required to maintain specific provisions, it would be appropriate to follow the New Accord treatment and vary the risk weight depending on the amount of specific provisions the banking organization has recorded.

The ABA believes that this provision represents overkill in capital standards. Banks already increase reserves (usually on a general, non-specific basis) against loans that become delinquent, and the reserves policy is carefully reviewed during external audits and examinations. Stepped up capital for delinquent exposures may therefore simply be offset with reduced additions to reserves. Perhaps more importantly, this provision will make capital requirements significantly more pro-cyclical, impair banks' ability to react to economic downturns, and restrain credit during such periods. The function of capital is to cushion against potential problems, not be a penalty for them. At the very least, bankers believe that, given that higher capital requirements for delinquent exposures would be double-counting, the risk weighting should be no higher than 100 percent.

For specific reserves for impaired assets, the ABA believes that those banks that establish such reserves (and thereby recognize immediate hits to earnings and capital) should not have to add capital. In establishing a specific reserve against a specific exposure, a bank has carefully evaluated the potential loss, subject to auditor and supervisor review. The risk is already addressed in the reserves, in that the specific reserve is deducted from regulatory capital. In fact, extra capital is already required, in addition to the deducted special reserve, in an amount equal to the risk weight applied to the residual exposure (the exposure less the specific reserve). With this conservative capital treatment, there is no need for a higher risk weighting for the residual exposure. Any additional capital requirement would simply be a pro-cyclical burden.

Risk-Weights: Fannie Mae and Freddie Mac debt. Under the current rules, government-sponsored enterprise (GSE) mortgage-backed securities and debt securities receive a risk weight of 20 percent. This risk weighting was assigned prior to the recent conservatorships of Fannie Mae and Freddie Mac and assumes that the U.S. Government will not stand behind the debt of the two companies. However, recent events have cast a new light on the support of the U.S. Government of Fannie and Freddie debt. Treasury recently took steps, including entering into Senior Preferred Stock Purchase Agreements with the GSEs, to support the GSE debt and to

support the mortgage market in order to improve the housing market, the U.S. economy, and the GSEs' business outlook.

The regulators recently proposed lowering the risk weight to 10 percent for (a) securities (excluding common or preferred stock) issued by, or other direct claims on, Fannie Mae and Freddie Mac, and (b) that portion of assets including claims on and the portions of claims that are guaranteed by those GSEs.[4] We support a lower risk weight. This not only is a better reflection of the risks to those banks that are holding the GSEs' debt, but is also particularly appropriate in light of the governmental policies that encouraged insured depository institutions to buy stock in the GSEs. We believe a lower risk weight is appropriate for the duration of the Preferred Stock Purchase Agreements. Once those agreements expire, then the risk weight should reflect whether the full faith and credit of the U.S. Government supports Fannie's and Freddie's debt.

We also believe it is very important to provide comparable risk weights treatment for Federal Home Loan Bank (FHLBank) debt held by banks, to prevent the unintended consequence of widening the spread between FHLBank debt and comparable debt issued by Fannie Mae and Freddie Mac. A similar approach to risk weighting will ensure consistency of treatment with all GSEs that support the housing market.

Risk-Weights: Bank premises. Currently, banks' land and buildings are risk-weighted at 100 percent. No mention of change of treatment for risk-weighting has been noted in the NPR for these assets. It is important to some banks – and particularly community banks -- to have the option to adjust the risk weight based on the book value of these assets. This allows the banks to deploy their capital more effectively and to utilize this capital to lend more money in their respective communities. For instance, the net book value of those assets less than or equal to 50 percent of appraised value could be risk-weighted at 20 percent; the additional net book value of those assets less than or equal to 70 percent could be risk-weighted at 75 percent; and the remainder of the net book value of those assets greater than 70 percent could be risk-weighted at 100 percent. Most bank properties are situated on prime locations and are well-maintained facilities. A sale of these assets would generally bring a profit and not a loss to the institutions.

Credit risk mitigation: Collateralized transactions. The proposed rule permits a bank to recognize the risk-mitigating effects of a broader range of financial collateral than is permitted under the current rule. A bank would be permitted to do so by using one of several approaches:

- The "simple" approach, where the bank substitutes the risk weight of the collateral for the risk weight of the exposure;
- The "collateral haircut" approach, whereby a bank applies a risk weight to an "adjusted exposure amount" (*i.e.*, the amount of the exposure minus the amount of collateral, plus the amount of collateral multiplied by a price volatility haircut); or

[4] 73 *Fed. Reg*. 63656 (Oct. 27, 2008). This lower risk weight would be available as long as the Treasury Department's Senior Preferred Stock Purchase Agreement dated September 7, 2008 remains in effect.

- With the regulator's approval, the "simple VaR" approach (for certain single-product netting sets of repo-style transactions and eligible margin loans).

The regulators also invite comment on a "zero H" approach, which would permit a zero haircut for repo-style transactions conducted with certain participants (like sovereigns, central banks, banks, and other financial institutions eligible for a 20 percent risk weight).

The ABA supports expanding the range of financial collateral that may be used as a credit risk mitigant. The current approach (which is based in large part on whether a security is issued by an OECD country or guaranteed by the U.S. Government or its Agencies) is unnecessarily restrictive and fails to reflect the reduction in risk brought about by the collateral.

The Agencies also invite comment on whether banks applying the Standardized Approach should be permitted to use the internal models methodology for calculating exposure amounts for OTC derivatives, eligible margin loans, and repo-style transactions. This is likely to have little impact on most ABA members. However, to the extent that a bank has invested in such models, it should have the option of using them if the bank's primary regulator finds the models sufficient.

Unsettled and Failed Transactions. The Agencies state in the NPR that they may waive the risk-based capital requirements for unsettled and failed transactions if there is a system-wide failure of a settlement or clearing system. The ABA supports this regulatory flexibility, as it is critical for banks during the occurrence of such extraordinary events.

Securitization Exposures. While the proposed treatment of securitizations is similar to the treatment required by the Advanced Approaches, we are concerned with the timing of the final Statement of Financial Accounting Standards (SFAS) 140 and other revisions pertaining to the accounting treatment of securitizations. Since it is very likely that resolution of SFAS 140 will not be complete by the time the final rule on the Standardized Approach is issued, we request that the final rule clearly address how SFAS 140 will impact the treatment of capital for securitizations. This would provide certainty for banks that utilize securitizations.[5]

In the NPR's provision on risk-weighted assets for securitization exposures, the Agencies state that a bank that engages in a traditional securitization would exclude the underlying exposures from the calculation of risk-weighted assets only if each of the following conditions are met: (a) the transfer is a sale under GAAP; (b) the originating bank transfers to one or more third parties credit risk associated with the underlying exposures; and (c) any clean-up calls relating to the securitization are eligible clean-up calls. The ABA is concerned that with the proposed SFAS 140 changes, ordinary course securitizations may no longer meet sale accounting treatment. We, therefore, urge the Agencies to reassess the need for sale treatment to serve as a prerequisite for capital relief, as they have indicated they would do should GAAP materially change. Given that this potential change to the interpretation of sale accounting does not reflect any change in the transfer of risk, there is no reason why capital requirements should be

[5] We urge the banking regulators to communicate with the Financial Accounting Standards Board (FASB), prior to any changes to SFAS 140 being adopted, about the potential impact that such changes could have on financial institutions.

modified. Additionally, Basel II does not include accounting sale treatment as a requirement for ordinary course securitizations. Thus, forcing a linkage between GAAP and capital requirements in this instance could result in competitive issues for U.S. banks.

Operational risk. The Agencies propose to use the Basic Indicator Approach (BIA), which requires banks to augment risk-weighted assets in an amount equal to 15 percent of the average positive annual gross income computed over the previous three years, multiplied by 12.5. Comment is invited on whether banks should have the option of using the Advanced Measurement Approaches (AMA).

The ABA believes that capital is not the best means to deal with operational risk. Far more important is the risk-management capability to deal with operational losses and the availability of insurance or other protections against such losses. The proposed BIA, by focusing solely on gross revenues as a proxy for operational risk, may not adequately correspond to the risk exposure. Thus, some ABA members continue to oppose inclusion of an operational risk component in the Pillar 1 formula and feel that this risk can only be appropriately addressed through Pillar 2 supervision.

Other ABA bankers, however, have accepted that the regulators (a) are committed to a formal Pillar 1 operational risk capital charge and (b) have calibrated other components of risk-based capital accordingly. The BIA presents an acceptable trade-off between simplicity and utility for some banks. Thus, if an operational risk charge remains in the final rule, we recommend that the BIA be retained as one option.

However, the BIA clearly suffers from several deficiencies. The base index of the BIA – "gross income," defined as net interest income plus non-interest revenues (averaged over three years, with years with negative income omitted) – can be a poor proxy for operational risk exposure for several reasons:

- First, high gross income may mean that an institution has many opportunities for operating losses, but it also may mean that competent management has controlled operational risk so that it impinges less on revenues. Indeed, lower gross income may reflect weaker management and more susceptibility to operational risk, and may lead an institution to scrimp on controls needed to manage operational risk. Moreover, the BIA treats interest income from credit risk and fees based on operational risk the same, even though the risks associated with the different lines of business that produce these different types of income are likely to vary widely.

- Second, the gross income proxy ignores the use of insurance, loss derivatives, and other measures to offset operational risk exposure. Indeed, there is no incentive to reduce operational risk, just gross income.

- Third, it penalizes banks that have high-margin, high-credit-loss balance sheets, such as credit card companies. These institutions may report very large gross income but without presenting any appreciable increase in operational risk.

- Fourth, the BIA may result in assessing a capital charge twice for the same asset. This could happen, for instance, by assessing a bank that holds high-yielding, low-rated mortgages a higher operational risk capital charge while simultaneously imposing higher credit risk charges.

- Fifth, the rule may result in a lower operational risk charge for a bank that is actively acquiring other banks or lines of business. These banks may have lower gross revenue (and, therefore, a lower operational risk capital charge) while presenting a heightened degree of operational risk as new and different systems get assimilated.

Given that gross income in the BIA may not be a good proxy for risk exposure, the ABA recommends that the final rule allow accepted alternative methods that may better measure operational risk and suit the nature and level of complexity of different banks' operations. We recommend that the final rule allow banks to use the Alternative Standardized Approach (ASA) in addition to the BIA.

The operations of most banks are reflected primarily in the commercial and retail assets on their balance sheets, so many bankers feel that a measure focused on those assets could provide a better gauge of operational risk exposure than gross income. The New Accord provides for the ASA, where the operational risk capital for commercial and retail exposures is based on net commercial and retail loans and leases; for other exposures it is based on the residual gross income. The ABA bankers who are interested in this option believe that the ASA would not involve excessive reporting burdens. For these reasons, the ABA recommends that this method be permitted along with the BIA.

We recommend further that the AMA from the Advanced Approaches rule be permitted. The NPR asks about this option and explains the rigorous implementation and supervisory expectations for the AMA. Some ABA members that are considering using the Standardized Approach prefer to use the AMA, either because they anticipate eventual migration to the Advanced Approaches to credit risk or because they see significant risk management benefits stemming from the rigor of the AMA. In fact, some of these already go through AMA-like review during regular examinations. This option would allow such institutions to use the systems they have developed for internal purposes in a regulatory standard. It would also encourage institutions to phase toward full implementation of the Basel II Advanced Approaches.

The ABA recommends that all three options – the BIA, ASA, and AMA – be available for each institution that adopts the Standardized Approach, absent some compelling supervisory reason to use one in particular. Flexibility among acceptable alternatives for operational risk needs to be included in the final rule in order for many institutions to consider using the Standardized Approach. This flexibility would not preclude supervisors from determining that the ASA does not effectively fit a bank's operations, because commercial and retail businesses are not primary product lines.

As noted above, insurance, loss derivatives, and other risk control tools can be far more important as an operational risk mitigant than capital. Among the three options, only the AMA recognizes the beneficial effects of such risk mitigants. The ABA recommends that the BIA and

ASA be amended to account for such risk mitigants. We accept that accommodation for insurance, etc., in the capital measure may be capped, as in the AMA, and may increase the complexity of the rule. Nonetheless, these factors are far too important to operational risk management to overlook. At a minimum, they should be included in any review of a bank's capital adequacy under Pillar 2.

Supervisory Oversight and Internal Capital Adequacy Assessment. As per the NPR, banks would be required to hold capital commensurate with the level and nature of all risks to which they are exposed, regardless of what is required under the Pillar 1 regulatory capital calculations. The regulators have been clear and consistent that Pillar 1 calculations yield the minimum capital appropriate for a given bank. If other risks are inadequately addressed in explicit capital charges imposed by the capital rules, those risks will be addressed during a review under Pillar 2.

The proposal provides little detail about what will be expected under Pillar 2 of banks that adopt the Standardized Approach. However, it is our understanding, based on a telephone conference of the ABA working group and representatives from each of the Agencies that have proposed the Standardized Approach, that regulatory expectations going forward, once the rule is adopted, are likely to be very similar to current expectations. While there currently is no formal "internal capital adequacy assessment process" (or ICAAP) requirement for banks complying with existing Basel I rules, the supervisory process nevertheless incorporates a review of each bank's capital adequacy. Thus, while the Basel II approach of relying on three pillars may appear to require something beyond what currently is required, this apparently is not the intention of the Agencies. If our understanding is incorrect, we urge the Agencies to specify precisely what would be different and to publish any such differences for comment along with the final Standardized Approach rule and before examining banks for compliance. Moreover, we note that any significant changes in either the level of information required by supervisors or the amount of additional capital required under Pillar 2 will create further disincentives for banks that otherwise might be inclined to implement the more risk-sensitive rules under the Standardized Approach.

Disclosures and Market Discipline. The proposal seeks to encourage market discipline through enhanced public disclosure. The Agencies note that most of what is proposed tracks disclosures currently required by banking, securities, or accounting rules.

The ABA does not oppose public disclosures for publicly-traded institutions. However, such disclosures should not be required for privately-held banking firms. Imposing a disclosure regime on these institutions would significantly frustrate many of the reasons why these institutions have elected to remain privately held.

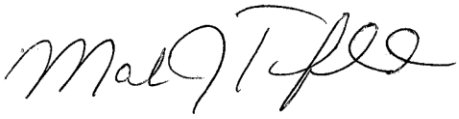
The proposal recognizes that proprietary information need not be disclosed. We appreciate the flexibility contained in the proposal and urge the regulators to adopt this provision in the final rule.

Conclusion

The ABA appreciates the opportunity to comment on the Standardized Approach Framework NPR, and we support its adoption in final form. While we have suggested numerous changes that we believe will improve the rule, we nevertheless believe that the Standardized Approach represents a significant improvement on, and an important option to, the current Basel I rules. We appreciate the Agencies' efforts to strike the appropriate balance between greater risk sensitivity and workability. It is important for every bank to have the option to select a rule that will result in a capital allocation that is most appropriate for that bank, consistent, of course, with the shared objective of safe and sound operations. We believe that the Standardized Approach will be a welcome alternative for many banks and that it will bring more consistency in the U.S. with the risk-based capital framework used in the international community.

We invite the staff of the Agencies to contact the undersigned at (202) 663-5042 or mtenhund@aba.com, Robert W. Strand at (202) 663-5350 or rstrand@aba.com, or Kathleen P. McTighe at (202) 663-5331 or kmctighe@aba.com, if they have any questions. Thank you for considering our comments and recommendations.

Sincerely,



Mark J. Tenhundfeld