ibfed International Banking Federation

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Subject: **Joint Notice of Proposed Rulemaking of the US Banking Supervisors on Risk-Based Capital Standards: Advanced Capital Adequacy Framework - OCC Docket Number 06-09; Board Docket No. R-1261; FDIC RIN 3064-AC73; OTS No. 2006-33/ RIN 1550 – AB 56**

Robert E. Feldman
Executive Secretary
Attention: Comments/ Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW.
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Comments@FDIC.gov

Jennifer J. Johnson
Secretary
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20th Street and Constitution Avenue, NW.
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Regs.comments@federalreserve.gov

Regulation Comments
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Washington, DC 20552
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Regs.comments@ots.treas.gov

Office of the Comptroller of the Currency
205 E Street, SW.
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Ladies and Gentlemen,

The International Banking Federation (IBFed) is the representative body for a group of key banking associations. Its members are the banking associations of Europe, the United States, Australia, Canada and Japan. The objective of IBFed is to increase the effectiveness of the financial services industry's response to multilateral and national government issues affecting their common interests. IBFed, which is based in London, became operational on 30 March 2004.

We welcome the opportunity to comment on the proposal put forward by the US banking supervisors on the implementation of the Basel II framework in the US. One of the core beliefs of the IBFED is that to take account of the global nature of the financial markets, supervisory rules and practices have to converge increasingly. All IBFED member federations have therefore strongly supported the Basel II project of agreeing on common supervisory rules for globally active institutions.

We hereby wish to renew our support for the work of the Basel Committee on Banking Supervision and for the robust and prudent framework that has been agreed with the Basel II Accord. We underline that to bring about the positive effects of a diminished administrative

burden on banks and of enhanced financial stability, it is crucial that there be a continued effort among the supervisors to achieve the convergence intended by the framework as an issue of first priority.

In addition, we would urge the US regulators to do their utmost to maintain the scheduled 2009 implementation date and avoid any further delays. The swift and clear endorsal of the Basel framework is at the current stage crucial to provide legal and planning certainty for banks. It should also draw a line under the debate on the Basel Accord, which was decisively shaped by the US regulators. However, if it appears in the process that a choice has to be made, it is clear in the IBFED's view that convergence should be given priority over the timing of the final rules.

The convergence concerns relate from our point of view in particular to the metrics as the underlying assumptions of the Accord, i.e. the definition of default and the risk parameters Exposure At Default and Loss Given Default. These issues are set out in more detail in the annex to this letter. Where there are doubts as to the appropriateness of the agreed rules, these should be discussed within the Basel Committee to avoid unilateral modifications. We furthermore continue to believe in the principle of rewarding good risk management practices and in its beneficial effects for financial stability.

With a view to the discussion on the introduction of a standardised approach, the IBFED considers that this would indeed greatly help the international consistency and compatibility of the rules. However, this would be subject to the close alignment of the US rules with those agreed by the Basel Committee on Banking Supervision, so as to avoid further divergences and allow both US and foreign-based institutions to broadly use the same standardised approach for their operations within and outside the US.

However, we also acknowledge that at this stage a certain degree of divergence seems unavoidable and is partly also needed to take account of local specificities. Pragmatic solutions will have to be found both for the divergences in the final rules and for the gap period. In our view, these solutions should as much as possible rely on the principle of mutual recognition. This follows logically from the agreement on a global Accord itself, but we recognise that it is also dependent on the existence of a good degree of trust among the authorities. We therefore take this opportunity to call on the supervisory community to continue its active dialogue not only in the Basel Committee, but also in bi- and multilateral relationships in supervisors' everyday-work.

We hope that you will find these comments helpful and trust that the US agencies, together with their colleagues in the Basel Committee, will do their utmost to work further towards supervisory convergence.

Yours sincerely,

Sally J Scutt

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## Annex to Response of the International Banking Federation:

**Joint Notice of Proposed Rulemaking of the US Banking Supervisors on Risk-Based Capital Standards: Advanced Capital Adequacy Framework - OCC Docket Number 06-09; Board Docket No. R-1261; FDIC RIN 3064-AC73; OTS No. 2006-33/ RIN 1550 – AB 56**

The International Banking Federation (IBFED) welcomes the opportunity to comment on the US regulators' joint Notice of Proposed Rulemaking on the implementation of the Basel II rules in the United States. In our view, the consistent and as far as possible convergent implementation of the rules is essential to bring about the intended benefits, in particular to effectively reduce the regulatory burden on banks and to ensure supervisory structures that allow a comprehensive understanding of the risks to which banks are exposed.

To this aim, we highlight three areas that should be addressed as a matter of priority. These are the three building blocks of the framework, i.e. the definition of default and the risk parameters Exposure At Default and Loss Given Default. The provisions currently proposed in the US diverge signicantly from those applied in other jurisdictions and from those proposed in the Basel framework and would imply difficulties for several reasons. In more detail, the differences are the following:

Divergence areas

- Definition of default

The Basel II framework defines an exposure as defaulted when it is between 90 and 180 days past due, depending on the exposure category. In contrast, the NRP establishes a past due threshold of 120 days in general and 180 days for retail mortgages. For wholesale exposures the default is based on a credit related loss of at least 5% of its initial amount in case of its sale.

Whilst both definitions are equally valid in principle, the divergence of these core parameters itself implies that for purely supervisory purposes, banks would have to run different systems for the calculation of their capital requirements within and outside the US.

- Loss Given Default

The US supervisors propose to replace the broad Basel II framework definition of Loss Given Default (LGD) with more onerous multiple LGD calculations for LGD, Expected LGD

(ELGD) and mapped LGD. The ELGD would be a default-weighted average of the loss expected to be incurred on a given loan. The definition of LGD proposed by the US would equal this amount plus an estimate of the additional loss expected in the case of adverse economic conditions. To convert ELGD estimates into LGD estimates banks would need explicit supervisory approval. Otherwise, a supervisory mapping function has to be applied that imposes *de facto* a conservative floor of in general 8%, and 10% for residential mortgages.

- Exposure At Default

Whilst the determination of Exposure At Default is not prescribed by the Basel II framework the NPR requires banks to estimate net additions to exposures. As a result, banks would have to collect fee information in the US, which they are not required to do in the rest of the world.

Implications of the divergences

These divergences are problematic for several reasons. First, in particular the different definitions of default are too far-reaching to allow banks to operate on a single, comprehensive risk management system. Instead, banks will have to run parallel systems which are costly to set up and to maintain. These would also not add any management benefit, but would on the contrary blur the picture of banks' overall risk exposure. In addition to this, the double systems also imply contradictions in the use test, as banks will have to choose one or the other methodology for their internal management but cannot comply with both at the same time.

There will also be a data collection burden as banks would in the future be required to collect data twice on the basis of two different sets of assumptions. Related to this, it will be impossible for many foreign-based institutions to comply with the US data requirements in the short term due to a paucity of US-applicable data.

Finally, the divergences would further complicate the Pillar 3 market disclosures and would make it very difficult for institutions to provide information that allows a meaningful comparison between its US-based and non-US subsidiaries.

Proposed solution

The IBFED respectfully submits that where possible, the US approach to Basel II implementation should be brought back in line with the Basel II framework, and especially regarding the definition of default. For any remaining divergences we suggest that the principle of mutual recognition be applied. We expect that the divergences in capital requirements remain limited, but where significant differences are identified they should be addressed through a bilateral dialogue between the concerned supervisors.

A third alleviation would lie in the introduction of the standardised approach in the US, provided that it remains close to the provisions agreed by the Basel Committee and already implemented in many other countries.

Whilst it is desirable that these changes be made as soon as possible, we finally reiterate that the convergence of the final rules should be prioritised over the timing.